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Anwar Shaikh[*]

WAGES, UNEMPLOYMENT AND SOCIAL STRUCTURE:

A NEW PHILLIPS CURVE

Abstract

There exist several economic theories on the inherent relationship between employment and inflation, and the connections with other economic variables.

The classical hypothesis posits a relation between the rate of change of the wage share and unemployment. The original Phillips curve shows that money wages raises in a nonlinear manner when unemployment is below some critical levels, and falls in a similar manner when unemployment is above that level. Furthermore, numerous scholars demonstrate through empirical analyses such relationship for different time series. This paper presents a study on US data considering differently and more efficiently data on employment and change of money wage. Noticeable changes are highlighted in the historical periods considered.

1. Introduction

Pre-Keynesian economics was characterized by the familiar notion of simultaneous equilibrium in all markets, including the full employment of

[*] Professor of Economics - Department of Economics, Graduate Faculty - New School for Social Research, New York, phone: (212) 229-5717, 1, E-mail: shaikh@newschool.edu.

workers in the labor market. All prices were assumed to function only as market-clearing variables. This attribution carried over to the labor market in which competitive real wages were assumed to only serve as labor market-clearing variables, their sole function being to maintain full employment. Workers admittedly bargained for real wages in order to achieve a standard of living, but in the end the living standard they got was the one that ensured their own full employment. In a perfectly competitive economy the struggle between labor and capital played no role in the determination of the *equilibrium* real wage (Shaikh, 2003, p. 129-132; Snowdon and Vane, 2005, pp. 37-54).

Keynes also based himself on competitive markets, since he believed that even "atomistic competition" could result in persistent unemployment (Leijonhufvud, 1967, p. 403)[1]. Yet in his case wage bargains and labor struggles played a big role. He was well aware of the neoclassical claim that unemployment would reduce the real wage, increase profitability and thereby move the system back toward full employment. Indeed, after the publication of the *General Theory* he conceded that persistent unemployment would erode not only money but also real wages (Bhattacharjea, 1987, pp. 276-279) so that *eventually* profitability, investment, output and hence employment would rise. Yet in the interim, in a society characterized by decentralized wage bargaining each wage reduction would have to be fought out at the local level, which would result in "wasteful and disastrous struggles" that could not be justified on social grounds (Snowdon and Vane, 2005, p. 66, citing Keynes). He therefore argued that in a crisis it would be far better to have the State engage in fiscal policy to directly increase aggregate demand and employment.

2. Inflation and the Phillips Curve

In the aftermath of the Great Depression and World War II, governments all over the developed capitalist world expressed a strong commitment to maintaining a high level of employment and rising levels of incomes – at least in the center countries. From this point of view, the period from 1950-1973 became viewed as a Golden Age sustained by to Keynesian policies (Snowdon and Vane, 2005, pp. 15-17). In neoclassical theory the system was

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[1] Kalecki's original argument on effective demand was in terms of "free competition" (Kriesler, 2002, pp. 624-625) which made it even more congruent to Keynes.

assumed to be normally at full employment (which subsumed normal frictional unemployment), so an increase in aggregate demand fueled by an increase in money supply would lead *only* to an increase in prices. In Keynesian theory the system was assumed to be normally below full employment, so an increase in aggregate demand would first increase output and employment up to the point of effective full employment and only then increase prices. Joan Robinson had already proposed at a theoretical level that prices would actually start to rise somewhat before full employment (Backhouse, 2003, pp. 460-461) and by the early 1960s this notion was operationalized by adding the Phillips curve to the basic Keynesian policy toolbox (Snowdon and Vane, 2005, p. 23).

   Phillips' (1958) original finding was that money wages rose in a nonlinear manner when unemployment was below some critical level, and fell in a similar manner when unemployment was above that level. He show that at empirical level from 1861-1957 the *cyclically-adjusted* rate of change of money wages in the UK was positive when unemployment was below a certain critical level u_L^* and was negative when unemployment was higher than this. His was a proposition about the trends, i.e. cyclically adjusted values, of the two variables. It implies an underlying curve of the shape in Figure 1, in which w = the money wage, $\dfrac{\dot{w}}{w}$ = percentage rate of change of wages and u_L = the unemployment rate.

Figure 1. The Phillips Curve
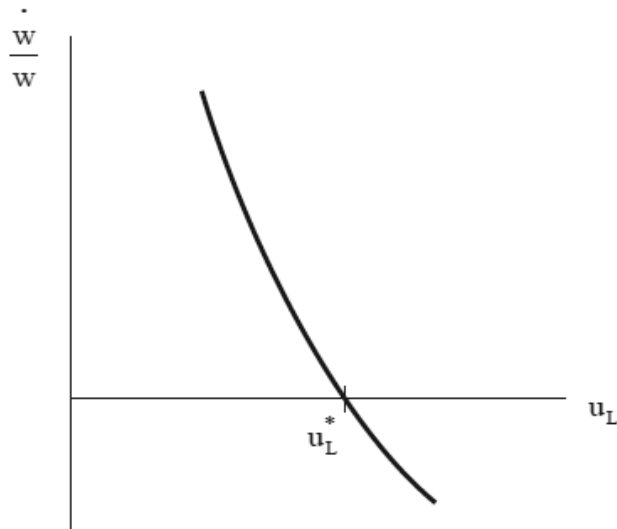
Source: our elaborations

Keynesian policies in the postwar period needed to have a concrete expression of the relation between inflation and unemployment, which was provided by transforming the money-wage Phillips curve into a money-price curve on the assumption that prices were formed as markups on money wages. The new relation posited that there was a stable negative relation between the rate of change of money prices (inflation) and the unemployment rate, as in Figure 2. This meant that policy makers could think of reducing employment below the critical level u_L^* in return for accepting some tolerably higher rate of inflation $\left(\dfrac{\dot{p}}{p} \right)$.

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Figure 2. The Inflation-Tradeoff Phillips Curve

$$\frac{\dot{p}}{p}$$

u_L^*

u_L
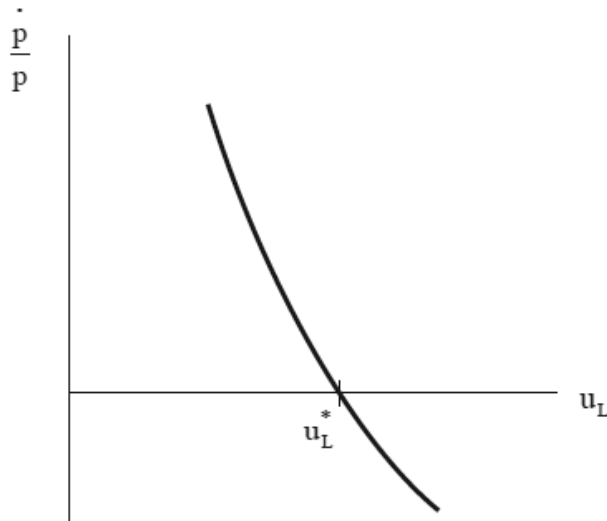
Source: our elaborations

3. The Rise and Fall of the Phillips Curve

Phillips' original data covered 1861-1957 in the UK, and early postwar data in other countries seemed to confirm Phillips' "law". For example, Figure 3 which compares the US inflation rate to its unemployment rate from 1955-1970 displays a clear Phillips' type relation. But as shown in Figure 4, over time the relationship began to fall apart and by 2010 there seemed to be no empirical support for the hypothesis (see the Data Appendix for all sources and methods).

Figure 3. Inflation vs. Unemployment, US 1955-1970
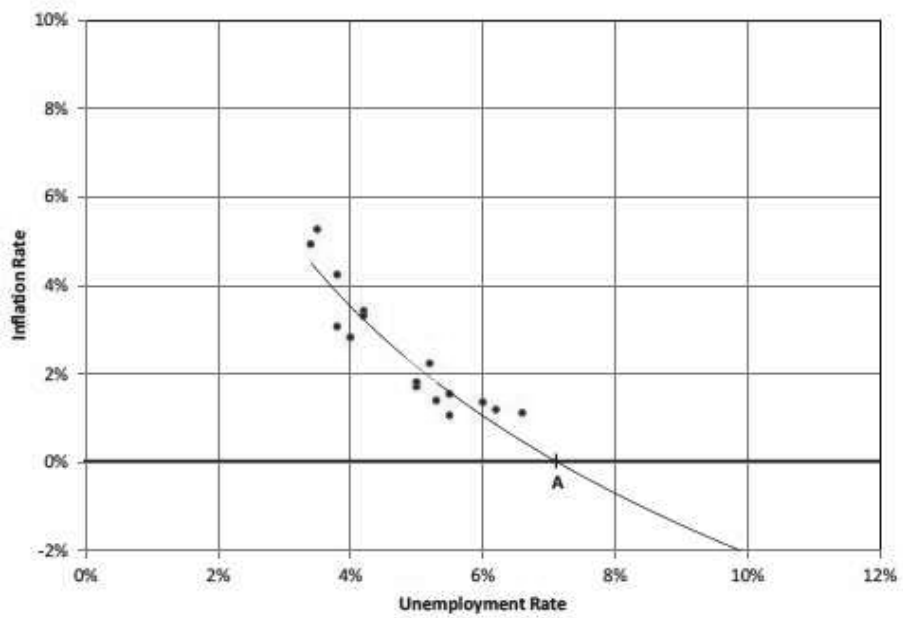
Source: our elaborations

Figure 4. Inflation vs. Unemployment, US 1949-2010
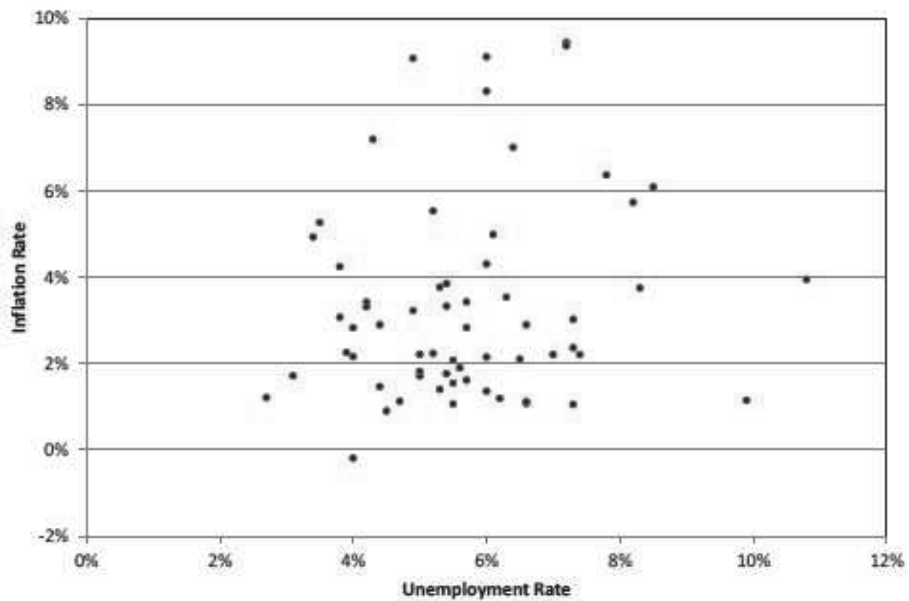
Source: our elaborations

Worse yet, between 1955-1970 and 1971-1986 unemployment rose substantially, yet instead of falling inflation *rose* even more. This directly contradicted Keynesian theory and undermined the notion of a stable Phillips curve.

Figure 5. US Inflation and Unemployment Rates, 1955-70 and 1971-1986
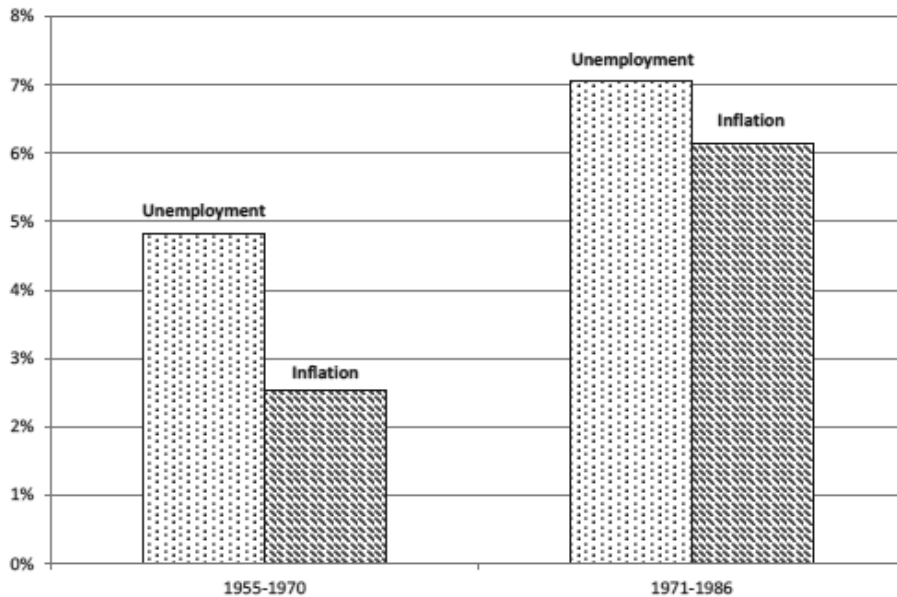
Source: our elaborations

4. Revenge of the Empire: The Neoclassical "Solution"

Keynesian theorists were trapped by the contradiction between their theory and the facts. According to their theory, inflation should have *fallen* when unemployment rose, while in practice inflation rose as unemployment rose. A great deal of Keynesian effort was expending in trying to solve this "paradox". But in the end the winning argument came from the neoclassical side when Friedman and Phelps stepped into the breach. They proposed two things. First, that the proper Phillips-type relation was between the rate of change of *expected real* wages and the unemployment rate, not the rate of change of actual nominal wages. Second, that in the long run the system *does* actually achieve effective full employment, so that any observed unemployment is voluntary because workers preferred unemployment or welfare to work, or induced by the state or unions which served to raise the real wage above the market clearing one (Blanchard and Katz, 1997, pp. 53-

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54; Friedman, 1977, p. 459).

I will not dwell on the Friedman-Phelps-Lucas debates on the dynamics of these propositions. For now, what is relevant is that when expectations are aligned with actual outcomes, neoclassical theory requires a stable negative relation between cyclically-adjusted real wages and the unemployment rate, i.e. *a real-wage Phillips curve*.

5. Phillips' question vs. his answer: a tale of three Phillips' curves

It is useful at this point to return to Phillips' original work, so as to distinguish between his *question* and his *answer*. Phillips' general question may be posed in terms of the effect of unemployment on wages. His particular answer was to link the rate of change of money wages to the rate of unemployment Friedman and Phelps assume that workers struggle for a standard of living, i.e. for a real wage, not a money wage. Hence from their point of view, the correct Phillips-type relation would be in terms of the rate of change of real wages.

However, in the classical tradition it has always been recognized that the real wage depends not only on the strength of labor relative to capital, but also on the general level of development of society, i.e. on *the level of productivity* (Dobb, 1973, pp. 91-92, 152-153). Thus from the classical point of view, an appropriate Phillips-type relation might be in terms of the rate of change of real wages relative to productivity, i.e. in terms of the rate of change of the *wage share*. Indeed, this *Classical Curve* appears as one of the two central dynamic relations in Goodwin's elegant formalization of Marx's argument that capitalism creates and maintains a persistent pool of involuntarily unemployed, reserve army of, labor (1967, p. 55). In addition to w, p as the previously defined wage rate and price level, let yr = the level of productivity and $\omega = \dfrac{(w/p)}{yr} = \dfrac{w}{p \cdot yr}$ = the ratio of the real wage to productivity, i.e. the wage share. Then the classical hypothesis is that

1) $\dfrac{\dot{\omega}}{\omega} = f(u_L)$ [Classical wage-share curve]

So we end up with three possible answers to Phillips's question: a Keynesian one in terms of the rate of change of money wages; a neoclassical one in terms of the rate of change of real wages; and a classical one in terms of the rate of change of the wage share. It is useful at this point to note that

the three curves must be related. Since $\dfrac{\dot{\omega}}{\omega} = \dfrac{\left(\dot{w/p}\right)}{\left(w/p\right)} - \dfrac{\dot{yr}}{yr} = \dfrac{\dot{w}}{w} - \dfrac{\dot{p}}{p} - \dfrac{\dot{yr}}{yr}$, if

the classical curve is valid we would expect from equation 1 that the real-wage Phillips curve would have productivity growth as a shift factor, and that the original money-wage Phillips curve would have inflation as a further shift factor.

$$2)\ \ \frac{\left(\dot{w/p}\right)}{\left(w/p\right)} = f\left(u_L\right) + \frac{\dot{yr}}{yr} \qquad \text{[Neoclassical real-wage curve]}$$

$$3)\ \ \frac{\dot{w}}{w} = f\left(u_L\right) + \frac{\dot{p}}{p} + \frac{\dot{yr}}{yr} \qquad \text{[Keynesian money-wage curve]}$$

6. Empirical Evidence for the US, 1949-2012

The classical hypothesis posits a relation between the rate of change of the wage share and some measure of unemployment. In the latter regard, it is striking that both the rate of unemployment and the duration of unemployment drifts upward in the 1970s-1980s and then rise again after 2008. But in the latter period, the unemployment duration rises much more sharply[2]. In order to take both features into account, a measure of *unemployment intensity* was constructed as the product of the unemployment rate and an index of unemployment duration, with the latter measure set equal to 100 in 1948-51. From this point of view, both the extent and the duration of unemployment can exert downward pressure on the ability of workers to secure increases in their real wages. We may think of the

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[2] BLS Series Id LNS13008275, http://data.bls.gov/pdq/SurveyOutputServlet

combined measure as an index of the number of worker-weeks of unemployment. Following Phillips' original procedure, all data is cyclically adjusted, in the present case by using HP-filtered values of the variables (see the Data Appendix).

Figure 6 examines the hypothesis of a classical curve by plotting the annual rate of change of the US wage share on the vertical axis against the unemployment intensity on the horizontal axis, both variables being represented by HP-filtered values. In addition, the direction of travel from year to year is indicated by the arrows attached to each point (the effect is quite striking when the data path is animated). The data path clearly indicates a break in the transition from the "golden age" for labor in 1948-1980 to the neoliberal Reagan-Thatcher era from 1994 onward. According there are also two fitted curves indicated by dotted lines fitted to the two eras 1949-1982 and 1994-2011 using Phillips' original functional form $y = a + bx^c$ where $y = \dot{\omega}/\omega$, x = unemployment intensity and a, b, c are fitted parameters (see the Data Appendix).

Figure 6. Rate of Change of Wage Share vs. unemployment intensity US 1949-2012 (HP filtered values)

Source: Our elaborations

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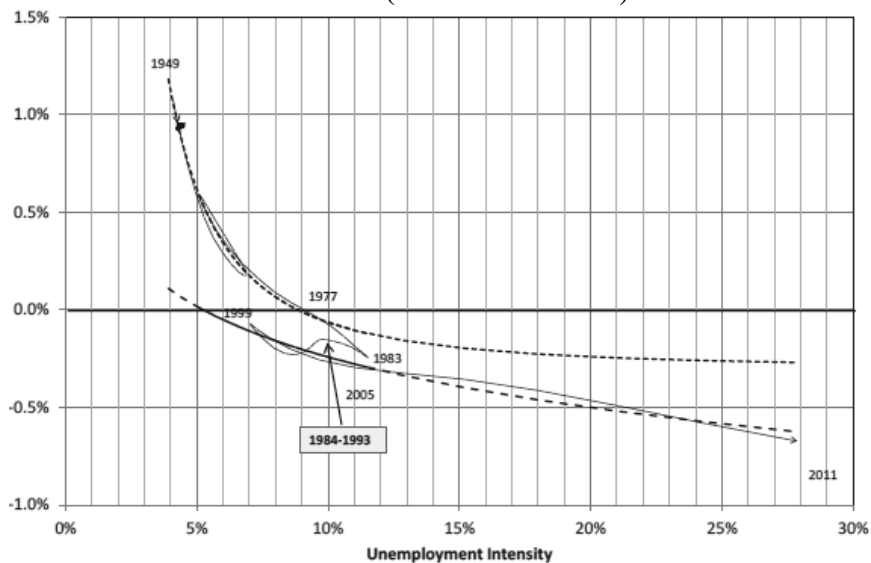
The data in Figure 6 has several striking features. First, there is a stable curve postwar classical curve from1948-1983, corresponding to a stable balance of power between labor and capital. Second, the economy moves back up this stable curve during the Vietnam War boom from 1960-1968, and then moves down it as the boom peters out after 1968. Third, the curve continues to hold even during the Stagflation Crisis of the 1970s and early 1980s. Fourth, the curve breaks up between 1984-1993 after labor is dramatically weakened during the Reagan-Bush era and the economy enters into a region of *falling* wage shares - which after all was the whole point. Fifth, a new stable curve is established from 1994 onward. Sixth, the Dot.Com credit bubble from 1993-1999 moves the economy upward along this new curve, and then back down it as the boom fades. The up and down movements along the respective curves in the Vietnam War and Dot.Com booms speak to the effects of sharp expansions of new purchasing power through the expansion of public or private deficit spending.

Finally, it is interesting to speculate that had Phillips answered his own question in classical rather than Keynesian terms, there might not have been a theoretical crisis for Keynesian policy during the Stagflation era of the 1970s and 1980s because it would have been understood that the money wage Phillips curve shifted with both the rate of inflation and the rate of productivity growth (equation 3). Hence there would not have been the same opening for the neoclassical counterattack on such policy. Of course, this need not have changed the possibility of a political attack aimed at weakening labor so as to raise the rate of change of the profit share by reducing the rate of change of the wage share (Shaikh, 2011).

Data Appendix

Bureau of Economic Analysis (BEA) GDP and the National Income and Product Account (NIPA) Historical Tables, http://www.bea.gov/national/index.htm#gdp, for prices, wages and productivity. p = the price level = the GDP Deflator from Table 1.1.9, line 1; w = the nominal wage = EC*100/FEE where EC = Compensation of employees, paid from Table 1.10, line 2; w/p = the real wage; yr = productivity = (GDP*100/p)/(FEE/1000), where GDP is from Table 1.10, line 1.

Bureau of Labor Statistics (BLS) for the unemployment rate (http://data.bls.gov/cgi-bin/surveymost?ln, series LNS14000000Q) and unemployment duration (http://www.bls.gov/cps/duration.htm, series LNS13008275). An index of unemployment duration was created using 1948-51 = 100, and unemployment intensity = unemployment rate x index of unemployment duration.

Rates of change of w, w/p, ω as well as the unemployment rate and intensity were filtered by the Hodrick-Prescott (HP) filter with the default parameter of 100. Finally, curves indicated by dotted lines in Figure 6 were fitted to the two eras 1949-1982 and 1994-2011 using Phillips' original functional form $y = a + bx^c$ where the dependent variable $y = \dot{\omega}/\omega =$ GWSHHP100, the independent variable x = unemployment intensity = ULINTENSITYHP100, and a, b, c are fitted parameters. The final equations were adjusted to remove non-significant parameters.

Dependent Variable: GWSHHP100
Method: Least Squares
Date: 05/25/13   Time: 18:42
Sample (adjusted): **1949 1982**
Included observations: 34 after adjustments
Convergence achieved after 4 iterations
GWSHHP100 = C(1)+((ULINTENSITYHP100)^C(3))

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	-1.026431	0.001418	-723.9645	0.0000
C(3)	-0.010677	0.000500	-21.35759	0.0000
R-squared	0.930871	Mean dependent var		0.003252
Adjusted R-squared	0.928711	S.D. dependent var		0.003145
S.E. of regression	0.000840	Akaike info criterion		-11.27011
Sum squared resid	2.26E-05	Schwarz criterion		-11.18032
Log likelihood	193.5918	Hannan-Quinn criter.		-11.23949
F-statistic	430.9021	Durbin-Watson stat		0.120899
Prob(F-statistic)	0.000000			

Source: Our elaborations

Dependent Variable: GWSHHP100
Method: Least Squares
Date: 03/03/13   Time: 15:00
Sample (adjusted): **1994 2011**
Included observations: 18 after adjustments
Convergence achieved after 4 iterations
GWSHHP100 = C(1)+ ULINTENSITYHP100^C(3)

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	-1.010996	0.000401	-2518.266	0.0000
C(3)	-0.003709	0.000175	-21.15025	0.0000
R-squared	0.964965	Mean dependent var		-0.002710
Adjusted R-squared	0.962775	S.D. dependent var		0.001758
S.E. of regression	0.000339	Akaike info criterion		-13.03610
Sum squared resid	1.84E-06	Schwarz criterion		-12.93717
Log likelihood	119.3249	Hannan-Quinn criter.		-13.02246
F-statistic	440.6863	Durbin-Watson stat		0.470611
Prob(F-statistic)	0.000000			

Source: Our elaborations

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Antonino Tramontana[*]

MONETARY POLICY, SUPPLY OF MONEY AND CREDIT TO THE REAL ECONOMY IN THE EURO AREA

Abstract

After the burst of the world financial crisis of 2007-2008 monetary policies, both in Europe and in the United States, by means of standard and nonstandard operations, have been pushed a long way beyond any limit previously attained, even in times of economic crises and depression.

But these policies, while able to provide a support to the banking systems, appeared less successful as instruments to provide a general recovery of the real economies.

The scope of the present paper is to investigate more properly the effects of the monetary policy of the European Central Bank (ECB) on the supply of money and on the level of credit to the real economy, namely to nonfinancial firms and corporations and to households in the euro area in order to clarify the real goals of this policy.

A set of interesting relationships can be found between the monetary base and the supply of money and between the supply of money and credit to the real economy. The role of the banking systems in the transmission mechanism of monetary policy is stressed, while the shortcomings of this policy with regard to the proper functioning of the money markets – owing to an enduring situation of negative real interest rates – and to the building of a noninflationary exit strategy from the crisis are highlighted.

JEL CLASSIFICATION: P24; D4; H81; E43.

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[*] Former professor of Public Finance at the University of Perugia, Italy. Viale Arrigo Boito, 126 - 00199 Roma (Italia).

KEYWORDS: MONEY AGGREGATES; BASE MONEY; OPEN MARKET OPERATIONS; LOANS TO NONFINANCIAL CORPORATIONS; REAL INTEREST RATES.

1. Introduction

In order to analyze more clearly the effects of monetary policy on the real variables of the economy in the euro area during and after the world economic and financial crisis a first step is to investigate more deeply the relationship between the monetary base (or base money) and the total supply of money.

Monetary policy carried out by the European Central Bank (ECB) through open market operations, or performed on demand of counterparties using marginal lending and deposit facilities, influences the amount of reserves held by the banking systems with their National Central Banks (NCBs) – which are the main component of the monetary base M0 (composed by currency and funds deposited in the Deposit Facilities and Current Accounts with the NCBs) – but not directly the supply of money.

When liquidity is released by the ECB through open market or marginal lending operations the supply of money, as measured by the money aggregates M1, M2 or M3[1], can increase only as a consequence of further operations carried out by credit institutions, which lend a part of the funds borrowed from the ECB to business firms, nonfinancial corporations or households, thereby increasing their current bank accounts or the amount of currency in circulation.

Instead, if credit institutions lend funds to other credit institutions through the interbank deposit markets or bilateral transactions or maintain in their

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[1] The European Central Bank defines three concepts of money aggregates: a narrow aggregate M1, an intermediate one M2 and a broad one M3, differing with regard to the degree of liquidity of the assets they include. M1 is defined as the sum of currency in circulation (banknotes and coins) and overnight deposits; M2 comprises M1 and deposits with an agreed maturity of up to two years or redeemable at a period of notice of up to three months; M3 comprises M2, repurchase agreements, money market fund shares and debt securities with a maturity of up to two years (including money market paper). See: European Central Bank (2004, pp. 36-38).

deposit facility or current accounts with the NCBs the funds obtained through open market or marginal lending operations, the transfer of funds allotted by the ECB to credit institutions entails only an increase in the monetary base M0, while the supply of money does not increase.

Because a great part of interbank transactions, as well as bank transactions with Governments which hold their accounts with NCBs, are settled in monetary base, the amount of this base and its velocity of circulation can greatly influence short term interest rates and the prices of assets traded by banks, even without an appreciable increase in the supply of money, while the supply of money influences the quantities and prices of real consumer and investment goods and services bought by business firms or households.

So it may happen that even in case of a great allotment of funds to the banking systems the supply of money, during a downturn of the business cycle, does not increase sensibly, being very low the demand for credit by nonfinancial firms and households. This demand can rise when it appears a better outlook of the conditions of the economic system and there is the risk that a great part of the monetary base previously accumulated becomes money through a sudden rise of the demand for credit by nonfinancial firms and households: in this case, a rapid and strong increase in the supply of money can increase the rate of inflation.

So given the amount of bank reserves R, the supply of money M1, M2, or M3 can be considered a function of nominal total demand for goods and services at time t D(t): in particular we have

$$M3 = f\,(R, D(t)),\ \text{with}\ dM3\,/\,dD(t) > 0.$$

2. The expansionary policy of the European Central Bank

Standard operations of monetary policy of the ECB are conducted through the weekly Main Refinancing Operations (MROs), the quarterly Longer Term Refinancing Operations (LTROs)[2] and, on demand of counterparties, the Overnight Lending and Deposit Facilities. The original impulses of monetary policy are transmitted to short term interest rates on monetary markets, to longer term interest rates on the financial markets, to the demand for goods and services for consumption and investment, to the labour market, to the level of production and prices etc.

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[2] For the structure of MROs and LTROs see: European Central Bank (2004, pp. 71-90). After the crisis many LTROs with longer maturities were launched.

In order to evaluate more properly the framework wherein the policies by the ECB (and of other central banks) were conducted it must be remembered that in the years preceding the crisis which broke out in year 2008 an enormous amount of low quality debt securities, partly deriving from securitization processes, has been issued with high rating on the financial markets, often by the so called Special Purpose Vehicles (SPVs) not bound by prudential rules and not subjected to oversight by monetary and financial authorities. To the indebtedness of the final utilizers of credit a high indebtedness of the financial intermediaries was added. So a great increase in the financial leverages and in the level of systemic risk occurred and some doubts arose about the solvency of some issuers.

Since the beginning of the financial turbulence in August 2007 the flow of liquidity in the money markets in Europe and in the US was severely hampered. A sharp reduction in the volume of exchanges in the interbank deposits markets and a rise in interest rates, especially on longer maturities, were the most prominent signals of the crisis[3].

Following the bankruptcy of the great American investment bank Lehman Brothers (15 September 2008) a global loss of confidence arose on the financial markets and a growing number of financial institutions were facing the risk of default.

A strong pressure was quickly exerted on Governments and Central Banks to run to the rescue of the financial systems.

The ECB reacted altering the size and maturity of its standard liquidity providing operations, both in euro and in foreign currencies as well as by reducing the level of interest rates on these operations and undertaking for the first time some non-standard operations.

So the strategy of the ECB underwent a radical change which implied not only a significant variation in the quantitative parameters of monetary policy, but also a net change in the same structure of its operational framework.

From October 2008 to May 2009 the ECB's minimum bid rates on the MROs were reduced by 325 basis points from 4,25%, to 1% while the rates on Marginal Lending Facilities (MLFs) were reduced by 350 basis points from 5,25% to 1,75% and the rates on Deposit Facilities by 300 basis points from 3,25% to 0,25%.

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[3] For a rapid overview of the policy conducted by the European Central Bank during the crisis see European Central Bank (2010, pp.63-71).

Furthermore the Governing Council of the ECB adopted a set of nonstandard measures focused on the banking systems and able to improve the functioning of the money markets to facilitate the transmission of monetary policy impulses and to support the supply of credit by banks to business enterprises and households.

Among these measures it is worth noting the provision to euro area banks of unlimited liquidity in euro at a fixed rate in main and longer term refinancing operations against the provision of eligible assets (collateral); the lengthening from three months to one year and then to three years of the maximum maturities of the LTROs; the extension of the list of assets accepted as collateral in monetary policy operations; the provision of liquidity in foreign currencies, especially US dollars, but also Swiss francs and Swedish kronor, by means of currency swap agreements with the respective Central Banks, the outright purchase of Covered Bonds at issue and on the secondary market and the outright purchase of government securities.

From May 13, 2009 to April 13, 2011, that is for almost two years, the interest rate on MROs and LTROs was maintained at the historical minimum of 1% with fixed rate tender and full allotment of total bid; the rate on marginal refinancing has been maintained at 1,75% and the deposit rate at 0,25%. The interest rate corridor on the interbank deposit market was fixed at 150 basis points.

These imposing expansionary measures soon influenced short term interest rates on the wholesale monetary markets. Particularly meaningful for its importance as a reference rate for mortgage loans is the EURIBOR 3-months rate. This rate, which reached the exceptional level of 5,11% on the average in October 2008, with a maximum of 5,39% on October 9, quickly declined in the following months, reaching 1,28% in May 2009 and going under 1% in the following month of July.

But the crisis entailed also an extraordinary downfall in the rate of inflation, which partly offset the effects of the reduction of nominal interest rates on the level of real rates.

In the month of December 2008, after many years, the rate of inflation fell under the target value of less but close to 2%, while after June 2009, negative inflation rates were signalling a situation of true deflation.

However, the rapid and strong reduction of short-term interbank interest rates did not entail a parallel reduction in retail rates, which mostly influence the economic situation of households and firms; retail rates, following often

with a certain slowness[4] the variations in wholesale money market rates (in the euro area EURIBOR rates) which measure the marginal cost of funding for banks, were somewhat reduced, but less than interbank rates.

The expansionary policies conducted by the main central banks of the world led their balance sheets to an unprecedented level; for the Federal Reserve System, the Bank of England and the Eurosystem total assets have arisen until around 20% of GDP, while the Bank of Japan reached 30% (Bank for International Settlements 2011, p. 50). The ECB has been compelled to follow the expansionary strategy of the Federal Reserve System and of the Bank of England also in order to prevent an overvaluation of the euro.

The increase in counterparty risk reduced exchanges and raised interest rates on the interbank deposit markets, which became unable to provide the necessary amount of funding: to counteract the effects of the crisis in Europe and reduce the mutual distrust between credit institutions a virtually unlimited volume of credit at very low nominal short-term interest rates was granted by the European Central Bank to the banking systems of the euro area through standard and nonstandard monetary measures since October 2008.

The phasing-out of nonstandard measures, many times announced by the ECB, has not yet been accomplished (European Central Bank 2010, p. 70).

On the contrary, further expansionary measures were taken by the ECB in November and December 2011 with the reduction of the minimum bid rates on MROs and LTROs which were raised in the preceding months of April and July 2011; an extraordinary LTRO has been launched on 21 December 2011 for an amount of 489billion euro at the interest rate of 1% and a maturity of 36 months which means an extraordinary provision of funds and reduction in the cost of funding for credit institutions. For the first time the reserve requirement ratio was reduced from 2% to 1%. One further exceptional LTRO took place on March 1, 2012 for an amount of 529.31 million Euro.

While in the first ten years of its activity the ECB and the Euro-system conducted only temporary open market operations (reverse repurchase agreements) providing liquidity, in the field of nonstandard measures an important though controversial step toward a more extensive use of

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[4] On the relationship between retail bank interest rates and money market rates see European Central Bank (2009, pp. 93-105).

monetary policy was undertaken by the ECB in June 2009, when, for the first time, a programme of outright purchases of securities with high rating issued by credit institutions (Covered Bonds), both at issue and on the open market, was launched (Covered Bonds Purchasing Programme or CBPP). In May 2010 a similar programme, the Securities Markets Programme (SMP) was launched for the outright purchase of government securities of euro area Countries. So a new task, though not clearly defined as a new target of policy, was assumed by the ECB: the task of limiting the increase of interest rates on the Public Debt of some Countries and so improving the stability of their public finances.

But this target could not be explicitly assumed by the ECB, owing to the potential conflict with the main target of price stability and with the principle of independence of the Bank and was justified with the intention of facilitating the transmission of the decisions of monetary policy to the financial markets and the real economy.

The Covered Bonds (CB) were purchased by the National Central Banks of the euro area, in proportion with their participation to the capital of ECB, for a total amount of 60 billion euro of nominal value. The programme was not intended as a simple means of increasing the liquidity of the system, but rather to improve the conditions of the Covered Bonds market and so to give a further financial support to the banking system.

In contrast with ordinary open market operations, where generally only government securities or securities guaranteed by governments are bought and sold on the secondary (open) markets, the CBPP was intended to buy only private securities, both at issue and on the secondary markets. Obviously purchases at issue have more penetrating and selective effects as means to support the issuers.

The implementation of this programme ended on June 30, 2010. In total, 422 different bonds were purchased, 27% in the primary market and the remaining 73% in the secondary market. The Euro-system mainly purchased bonds with maturities of three to seven years, which resulted in an average modified duration of 4,12 years for the portfolio, as of June 2010.

The Euro-system intended to hold the bonds until maturity and has been lending some of them to counterparties who wished to borrow such bonds against eligible collateral.

The outright purchases of Covered Bonds, conducted following the programme launched in June 2009, as well as the purchases of government bonds in the framework of the Securities Markets Programme (SMP)

launched in May 2010, were settled on the basis of bilateral transactions between the ECB or the NCBs and selected counterparties.

At the end of 2012 218 billion euro of government bonds were purchased by the Eurosystem through outright operations so divided by Countries:

Italy: 102,8, Spain: 44,3, Portugal: 22,8, Ireland: 14,2, Greece: 33,9.

Given the importance of outright operations in the field of monetary policy, as well as in the field of a more general European economic policy and in order to ensure their transparency, impartiality and competitiveness, it would have been necessary to follow the same rules applied to temporary open market operations and to purchase the bonds through ordinary tender auctions open to a great number of counterparties, instead that through bilateral transactions only with counterparties directly selected by the ECB.

The effects of outright operations on liquidity could be neutralized if the ECB might finance the purchase of government bonds by the issue of own bonds of the same maturity at lower interest rates.

But the problem of outright open market operations as a means to face the financial crisis was considered in a more systematic fashion only in the summer of 2012.

Addressing the ECB press conference on 2 August 2012 the President Mario Draghi said that exceptionally high risk premia were observed in government bond prices in several countries and financial fragmentation hindered the effective working of monetary policy.

In order to eliminate these risk premia the countries of the euro area should implement fiscal consolidation, structural reforms and European institution-building with great determination and stand ready to activate the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) when exceptional financial market circumstances and risks to financial stability exist.

The adherence of governments to their commitments and the fulfillment of their role by the EFSF and the ESM were considered necessary conditions in order to allow the ECB to undertake outright open market operations (Outright Monetary Transactions or OMT), limited to the purchase of short term government securities, of a size adequate to reach its objective, as well as other non-standard monetary policy measures according to what is required to repair monetary policy transmission.

It should be noted, however, that if this transmission is hindered by an excessive steepness of the curve describing the term structure of interest rates, a more appropriate strategy of monetary policy would be a "twist

operation" whereby the Eurosystem could invest the proceeds of maturing short term government securities in the purchase of longer term securities, so flattening the curve without altering the total level of liquidity of the system.

3. Monetary Base, Supply of Money and Liquidity

In the Euro Area the monetary base M0 is composed by currency, overnight deposit facilities accounts and current accounts held by credit institutions with the Eurosystem. The divergent developments of M0 and of the monetary aggregate M3 after the outbreak of the world crisis are worth noting.

In order to evaluate the impact of monetary policy on the supply of money in the euro area it may be helpful to compare the evolution of bank reserves held with NCBs and the evolution of the broad monetary aggregate M3; despite the assumptions of simple models of monetary theory these variables are generally not connected by a constant monetary multiplier[5].

In the year preceding the crisis the annual rate of growth of M3 is very high (between 10% and 11%), marking a substantial growth of credit to the private sector as well as a portfolio reallocation from longer maturity assets to monetary assets, owing to an almost flat curve of term interest rates.

But since the summer 2008 we observe a constant reduction in this rate of growth despite a growing flow of liquidity from the Eurosystem. From the beginning of October till the end of December 2008 the liquidity supplied by the ECB to the banking systems through Long Term Refinancing Operations (LTROs) – and still existing at the end of December – reached the huge amount of 583,4 billion euro while, in the same time, the money aggregate M3 grows only by 158,2 billions and at the end of November was 6 billion lower than at the end of October. A great amount of funds borrowed was deposited by credit institutions on current and overnight Deposit Facility accounts held with the respective National Central Banks. Therefore these funds maintained the nature of monetary base and did not become money.

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[5] For a recent criticism of the traditional monetary multipliers and a deeper analysis of the relationship between liquidity produced by Central Banks and the supply of money (or outside and inside money) see: European Central Bank (2011, pp. 63-79).

The average quarterly rate of growth of M3 over the same period of the preceding year, which was 9,2% in July 2008, decreases to 7,0% in the following month of December, to 4,5% in April 2009 and to 3,7% in May 2009. In this last month, therefore, the growth rate of M3, for the first time after many years, decreases under the level fixed as its reference value since the beginning of the operation of the Eurosystem, namely an annual rate of 4,50%.

The rate of increase of M3 remains very low even in year 2010, as can be seen from Table 1. This rate, which was negative or zero until the month of May, rises to 1,2% in August, and to 1,7% in the following month of December.

Table 1. Amount and % Rate of Growth of M3

Month	M3 Outstanding Amount (billion euro)	% Rate of Growth over the same period of the preceding year
January 2010	9.302,5	0,0
February	9.311,8	- 0,4
March	9.323,5	- 0,1
April	9.384,8	- 0,2
May	9.365,2	- 0,2
June	9.419,2	0,2
July	9.435,2	0,2
August	9.522,9	1,2
September	9.500,7	1,1
October	9.469,7	0,9
November	9.631,2	1,9
December	9.523,9	1,7

Source: All data are drawn from the Monthly Bulletins of the European Central Bank.

The liquidity which does not become money swells the various accounts held by credit institutions with their National Central Banks.

Enormous and anomalous is the amount of deposits held by credit institutions as Deposit Facilities with the Eurosystem in the first months of 2009, reaching 238,5 billion euro in the reserve maintenance period ending on 20 January 2009, as can be seen in Table 1, especially considering that, in

normal times of the preceding years this amount fluctuated between 300 and 600 million euro only.

In the first and second quarter of year 2009 the amount of liquidity provided to the banking system of the euro area through longer term refinancing operations (LTROs) and existing on 30 June 2009 reached 717,9 billion euro but, despite this enormous increase in the amount of liquidity, the amount of M3 in June 2009 was only 39 billion higher than in December 2008, while the amount outstanding in the following month of July was only 62 billion higher than in December 2008.

Funds deposited in the Deposit Facilities held by credit institutions with the Eurosystem show a high and growing level until June 2010. Being at 1% the rate of interest on MROs and LTROs and at 0,25% the rate on the Deposit Facility, this decision shows a growing preference on the part of credit institutions to obtain and maintain liquidity from the Eurosystem at a total cost of 0,75% (1% – 0,25%), rather than obtain it in the interbank market, despite the low level of the EONIA rates during this period.

The ratio between the increase in the monetary aggregate M3 and the increase in the monetary base M0, that is the marginal ratio dM3 / dM0, or monetary multiplier of the monetary base, is an important variable in the analysis of monetary policy; it tends to decrease in the downturn and to increase in the upturn of the business cycle. In the last quarter of 2008 its value was approximately 0,27.

 Divergent developments between the monetary base and the supply of money in the course of the financial crisis can be found also in the United States but the difference is lesser than in Europe. While from July 2008 to January 2010 the monetary base grew by about 865 billion dollars, the money supply, as measured by aggregate M2, grew from August 2008 to January 2009 by 528 billion[6]. Probably in the US a greater share of the

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[6] Source: US Federal Reserve System. In the US M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCDs), consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions. Seasonally adjusted M1 is constructed by summing

monetary base than in Europe flew from the financial network into the real economy, so becoming money.

In the euro area the evolution of the Monetary Base M0 and of Monetary Aggregate M3 in years 2011 and 2012 is depicted in the following tables and in figures 1 and 2.

Table 2. The Monetary Base M0 and the Monetary Aggregate M3 Year 2011 (Billion Euro)

Year 2011	M0	M3
January	1.112,7	9.565,6
February	1.074,8	9.572,6
March	1.060,7	9.594,3
April	1.057,9	9.584,9
May	1.066,1	9.647,3
June	1.064,0	9.651,5
July	1.086,6	9.690,7
August	1.122,4	9.806,1
September	1.184,5	9.847,2
October	1.232,2	9.783,6
November	1.274,8	9.773,9
December	1.335,3	9.716,3

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currency, traveler's checks, demand deposits, and OCDs, each seasonally adjusted separately.

M2 consists of M1 plus (1) savings deposits (including money market deposit accounts); (2) small-denomination time deposits (time deposits in amounts of less than $100.000), less individual retirement account (IRA) and Keogh balances at depository institutions; and (3) balances in retail money market mutual funds, less IRA and Keogh balances at money market mutual funds. Seasonally adjusted M2 is constructed by summing savings deposits, small-denomination time deposits, and retail money funds, each seasonally adjusted separately, and adding this result to seasonally adjusted M1.

**Figure 1. Monetary Base M0 and Monetary Aggregate M3
Year 2011 (Billion Euro)**
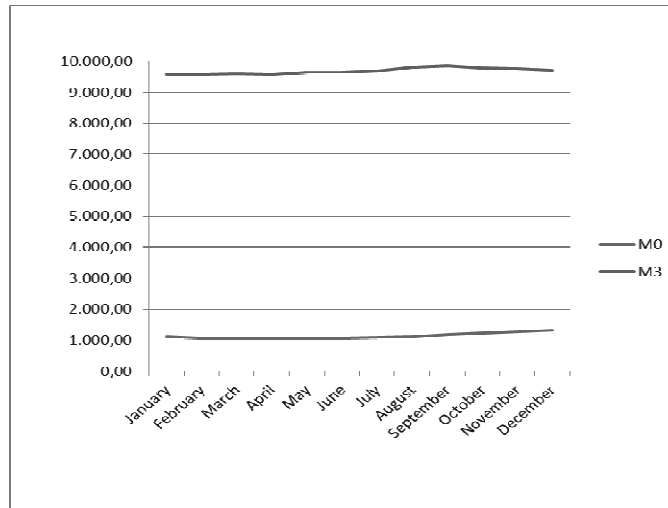
**Table 3. The Monetary Base M0 and the Monetary Aggregate M3
Year 2012 (Billion Euro)**

Year 2012	M0	M3
January	1495,3	9764,7
February	1467,1	9827,1
March	1598,6	9881,5
April	1752,1	9833,4
May	1754,6	9621
June	1762,3	9640,9
July	1774,6	9708,8
August	1751	9723,9
September	1766,2	9686
October	1736,2	9796
November	1675,3	9787
December	1631	9740,5

Figure 2. Monetary Base M0 and Monetary Aggregate M3 Year 2012 (Billion Euro)
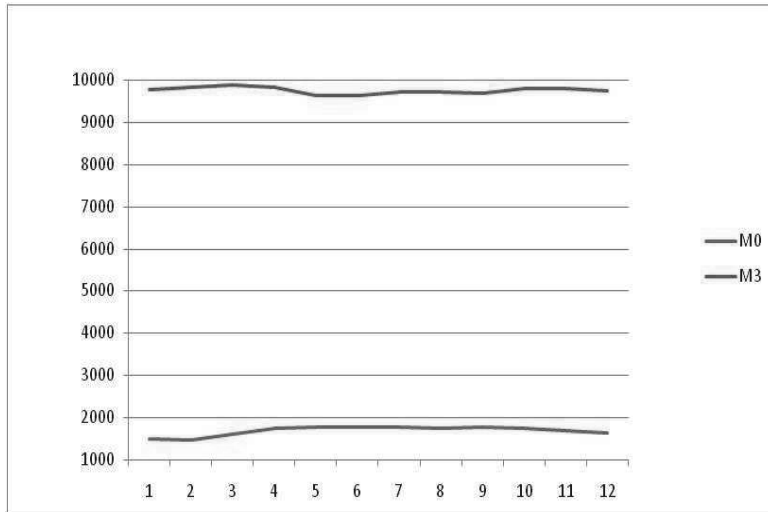
Figure 3. M3 as a Function of M0 in Year 2012
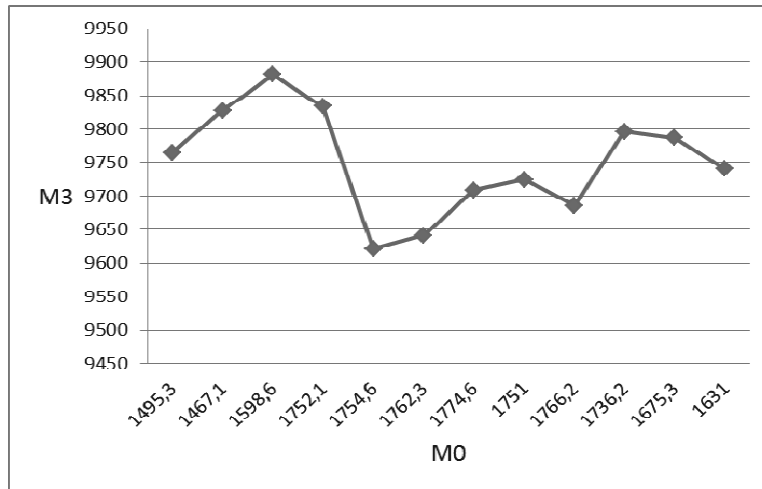
While in July 2011 the Monetary Base was 1.086,6 billion euro, it raised to 1.774,6 billion in July 2012 with an increase of 688 billion euro (+63,3%), owing to the great allotment of liquidity provided by LTROs especially in December 2011 and February 2012, the monetary aggregate M3 in the same period rose only by 18 billion euro (+0,18%) from 9.690,7 to 9.708,8 billion euro.

Looking at the components of bank funds deposited with the Eurosystem we note the development of Deposit Facilities and Current Accounts in year 2011 and 2012.

Overnight Deposit Facilities and Credit Institutions Current Accounts in years 2011 and 2012 are shown in the following tables.

Table 4. Overnight Deposit Facilities and Credit Institutions Current Accounts Year 2011

Year 2011	Deposit Facility	Current Accounts	Total
January	66,5	212,4	278,9
February	39,2	213,6	252,8
March	26,9	212,9	239,8
April	23,0	210,5	233,5
May	22,8	209,5	232,3
June	18,4	209,0	227,4
July	29,5	210,9	240,4
August	56,9	211,5	268,4
September	121,8	209,5	331,3
October	168,7	208,7	377,4
November	204,6	208,9	413,5
December	253,7	212,2	465,9

Table 5. Overnight Deposit Facilities and Credit Institutions Current Accounts Year 2012

Year 2012	Deposit Facility	Current Accounts	Total
January	399,3	212,3	611,6
February	489	108,1	597,1
March	621	108,9	729,9
April	771,3	109,6	880,9
May	771,4	110,5	881,9
June	770,8	110,8	881,6
July	770,6	111,5	882,1
August	343,1	510,2	853,3
September	328,6	540	868,6
July	770,6	111,5	882,1
August	343,1	510,2	853,3
September	328,6	540	868,6

The extraordinary growth of funds in the Deposit Facilities since January 2012 followed the great LTROs undertaken by the ECB in December 2011 and February 2012, for the first time with maturity of 3 years at an interest rate of 1%.

After the reduction to 0 of the rate of interest on overnight deposits with the Eurosystem in July 2012 a substantial amount of funds was transferred by credit institutions since August 2012 from the Deposit Facilities to Current Accounts, more easily manageable for their ordinary operations.

So in year 2012 the divergent evolution of the monetary base M0 and the money aggregate M3 become very impressive and the total amount of bank funds deposited with the Eurosystem becomes the main component of the monetary base.

This divergence reflects in a very simple way the growing divergence between a very liquid financial system and a slack real economy.

4. Loans to nonfinancial corporations and households

The great expansionary policy undertaken by the ECB in the years following the burst of the crisis, though conducted by an extraordinary mix

of standard and non-standard operations, did not promote a stable recovery in the European real economy.

The financial crisis and the outlook of a serious downturn in the world economy entailed an increase in the default risk of enterprises and a tightening of terms and conditions for obtaining bank loans, causing a further slowing down in the process of adjustments of retail rates to the decrease of interbank rates[7].

So it has been observed that "As the economy gradually improves, banks' capital bases are reinforced and their risk-taking behavior normalizes, it will be essential for banks to increase their lending activity" (European Central Bank 2009, p.105).

Since the liquidity shortage has been more acute on longer maturities of the money market, the ECB has further enhanced the role of LTROs – already enlarged in the months immediately preceding the burst of the crisis – by lengthening the maturities of the operations and increasing the amount of liquidity allotted.

By means of these operations, the monetary policy of the ECB has been able to improve the general economic situation of credit institutions and to partly overcome the difficulties encountered by them on the interbank money markets, particularly relevant because the crisis was displayed first of all with an increase in interest rates and a reduction of the volume of exchanges on this market.

Less effective has been the policy of credit support to the banking system in order to expand the volume of bank loans to nonfinancial corporations and households. Only in part this increase has been realized and often there has been no increase at all. So the expansionary impact of this policy on the economic system as a whole has been reduced. Clearly this policy cannot produce an expansionary effect similar to that of traditional fiscal policy which acts directly on the level of total demand for goods and services. The banking systems, receiving great amounts of liquidity from the Euro-system at a very low fixed rate of interest (presently under 1%) even for maturity until three years, buys great amounts of low risk securities (especially government securities) which produce yields greater than 1% and so gets very high profits. More risky loans to the private sector of the economy are discouraged and do not expand.

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[7] Sometimes the increase in the spreads applied to loans accorded to customers has, at least partly, offset the reduction in the EURIBOR rates.

The effects of monetary policy on the amount of credit accorded to the real economy in the euro area are best described by the data of loans to nonfinancial corporations, L1 and loans to households, L2, in the years following the outbreak of the crisis. Data relating to the outstanding amounts of these loans and to their respective % rates of growth on the corresponding period of the precedent year are shown in Tables 6 to 9 and in Figures 4 to 11 for year 2009 to 2012.

Table 6. Loan to Non-Financial Corporation, L1 and to Households L2 (Euro Billions) 2009

Month	L1		L2	
	Outstanding amounts	% Growth Rates	Outstanding amounts	% Growth Rates
January	4.884,60	9	4.898,90	1,2
February	4.880,00	7,8	4.899,20	0,7
March	4.848,30	6,3	4.889,60	0,4
April	4.840,80	5,2	4.888,10	0,0
May	4.827,30	4,4	4.887,20	- 0,1
June	4.789,60	2,8	4.891,20	0,2
July	4.764,50	1,6	4.892,70	0,0
August	4.766,50	0,7	4.900,30	- 0,2
September	4.751,50	-0,2	4.909,90	- 0,3
October	4.730,40	-1,2	4.918,90	- 0,1
November	4.721,50	-1,9	4.931,30	0,5
December	4.686,00	-2,2	4.943,50	1,3

Figure 4. Loan to Non-Financial Corporation, L1 and to Households L2 (Euro Billions) 2009
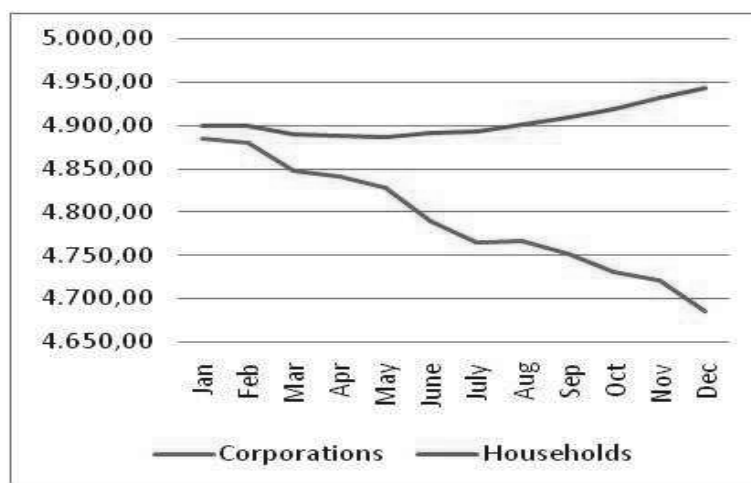
Figure 5. % Rate of Growth 2009
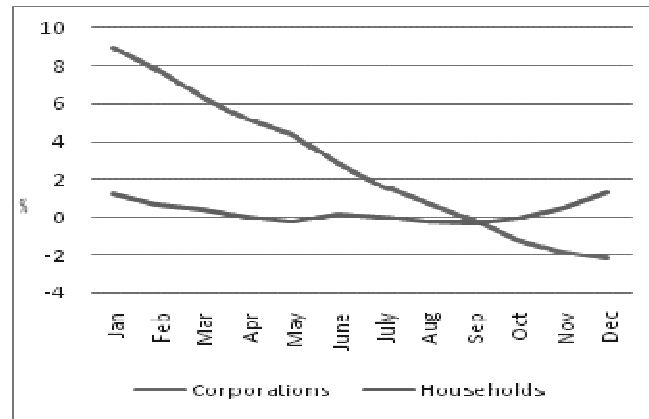
Table 7. Loan to Non-Financial Corporation and to Households (Euro Billions) 2010

Month	L1		L2	
	Outstanding amounts	% Growth Rates	Outstanding amounts	% Growth Rates
January	4.685,7	-2,7	4.954,2	1,6
February	4.689,9	-2,4	4.959,4	1,8
March	4.680,5	-2,4	4.971,6	2,1
April	4.667,6	-2,6	4.980,6	2,5
May	4.688,3	-2,1	5.014,0	2,6
June	4.689,5	-1,7	5.087,4	2,7
July	4.664,7	-1,4	5.087,4	2,7
August	4.686,3	-1,1	5.107,4	2,9
September	4.699,6	-0,6	5.108,2	2,8
October	4.685,1	-0,5	5.123,1	2,9
November	4.698,3	-0,1	5.141,0	2,8
December	4.665,2	-0,2	5.157,9	3

Figure 6. Loan to Non-Financial Corporation and to Households (Euro Billions) 2010
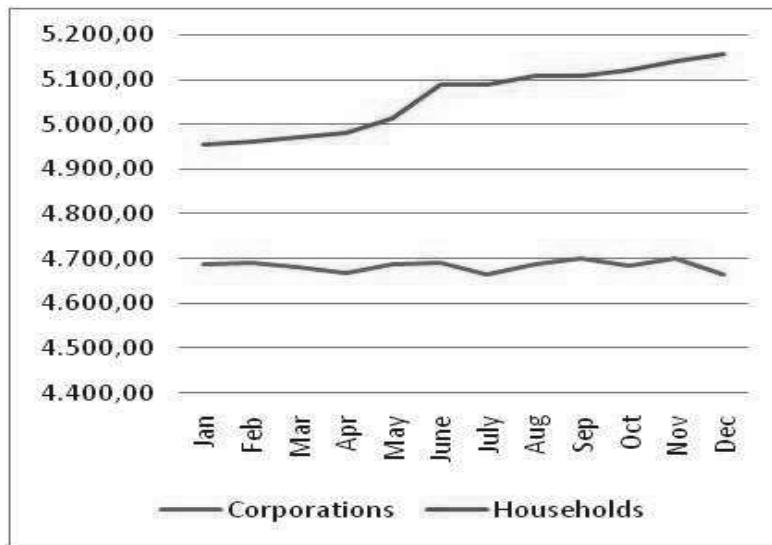
Figure 7. % Rate of Growth 2010
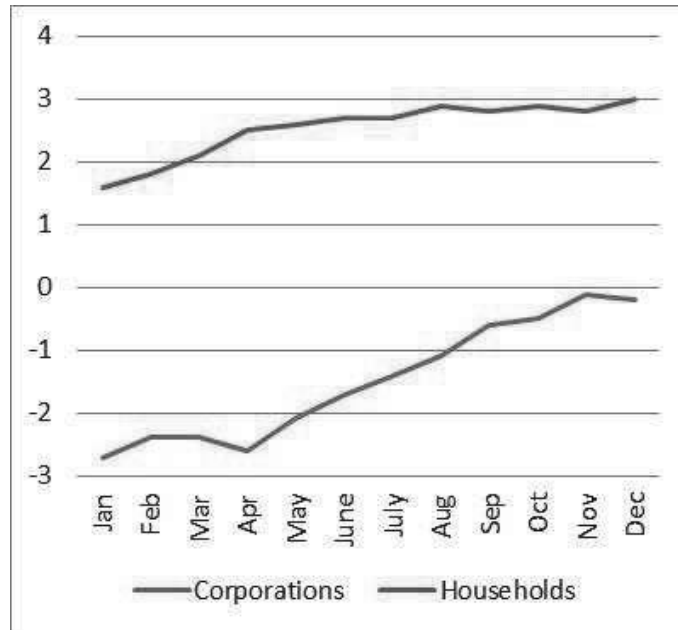
Table 8. Loan to Non-Financial Corporation and to Households (Euro Billions) 2011

Month	L1		L2	
	Outstanding amounts	*%* Growth Rates	Outstanding amounts	*%* Growth Rates
January	4.699,5	0,5	5.182,3	3,1
February	4.705,70	0,6	5.184,4	3
March	4.705,4	0,8	5.217,6	3,4
April	4.700,5	0,9	5.225,7	3,4
May	4.717,8	1	5.242,2	3,4
June	4.740,6	1,5	5.262,5	3,2
July	4.744,4	1,6	5.259,2	2,9
August	4.721,5	1,5	5.264,0	2,9
September	4.755,0	1,6	5.275,3	2,9
October	4.751,2	1,9	5.233,8	2,2
November	4.757,8	1,6	5.243,1	2,1
December	4.720,8	1,1	5.242,8	1,6

Figure 8. Loan to Non-Financial Corporation and to Households (Euro Billions) 2011
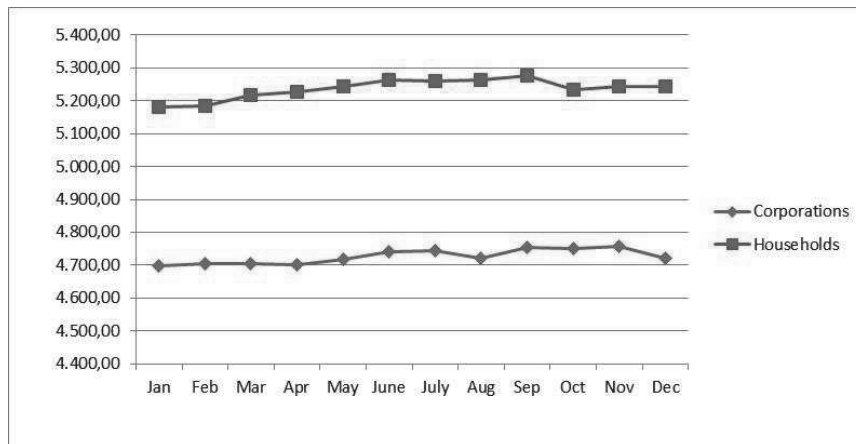
Figure 9. % Rates of Grow of Loans and M3 in Year 2011
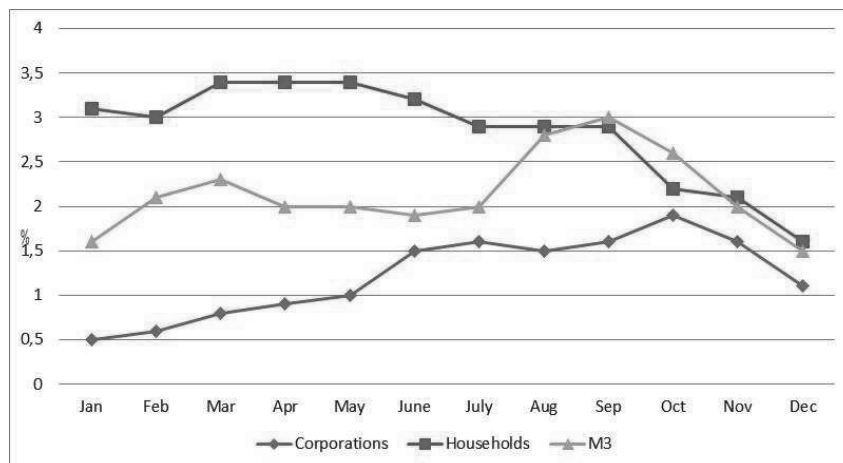
Table 9. Loans to Non-Financial Corporations and Households (Euro Billions) 2012

Month	L1		L2	
	Outstanding amounts	% Growth Rates	Outstanding amounts	% Growth Rates
January	4.722,4	0,7	5.236,3	1,3
February	4.710,9	0,4	5.238,4	1,2
March	4.699,3	0,3	5.231,3	0,6
April	4.703,1	0,4	5.234,2	0,5
May	4.703,7	0,1	5.240,8	0,3
June	4.697,8	-0,6	5.256,5	0,2
July	4.703,6	-0,4	5.246,3	0,2
August	4.667,1	-0,7	5.244,6	0,2
September	4.653,3	-1,5	5.245,2	0,1
October	4.638,5	-1,8	5.244,6	0,4
November	4.636,8	-1,8	5.252,8	0,4
December	4.542,0	-2,3	5.254,1	0,5

Figure 10. Loans to Non-Financial Corporations and Households (Euro Billions) 2012
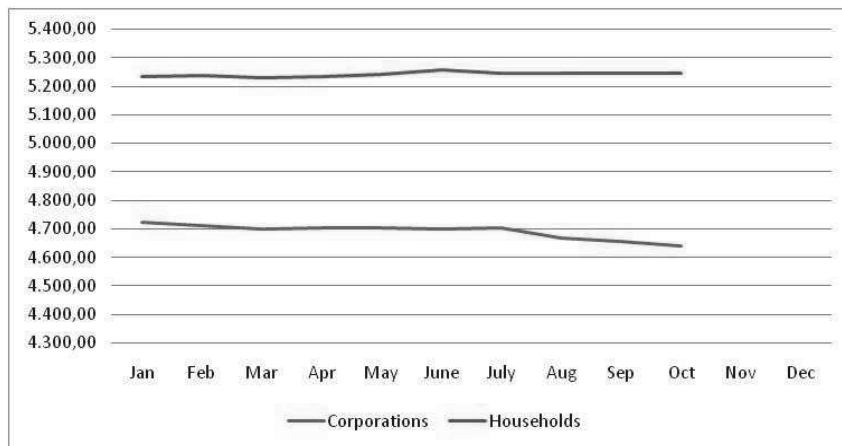
Figure 11. % Rates of Growth of Loans and M3 in Year 2012
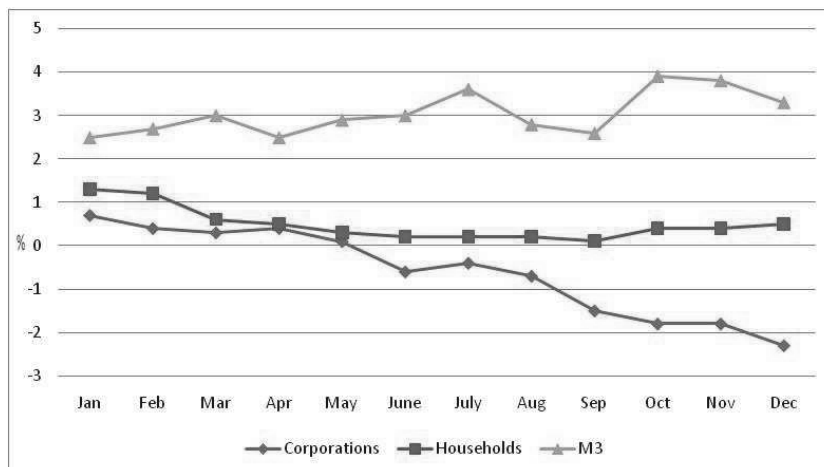
Table 10. % Growth Rates of L1, L2 and M3 in year 2012

Month	L1	L2	M3
January	0,7	1,3	2,5
February	0,4	1,2	2,8
March	0,3	0,6	3,2
April	0,4	0,5	2,6
May	0,1	0,3	3,1
June	- 0,6	0,3	3,2
July	- 0,4	0,2	3,6
August	- 0,7	0,2	2,8
September	- 1,5	0,1	2,6
October	- 1,8	0,4	3,9
November	- 1,8	0,4	3,8
December	- 2,3	0,5	3,3

Table 11. 3-month deposits EURIBOR – % Nominal and real interest rates in year 2012

Month	Nominal Rate %	Increase % HICP	Real Rate %
January	1,22	2,7	-1,48
February	1,05	2,7	- 1,65
March	0,86	2,7	-1,84
April	0,74	2,6	-1,86
May	0,68	2,4	-1,72
June	0,66	2,4	-1,74
July	0,50	2,4	-1,90
August	0,33	2,6	-2,27
September	0,25	2,6	-2,35
October	0,21	2,5	-2,29
November	0,19	2,2	-2,01
December	0,19	2,2	-2,01

In year 2009 loans to nonfinancial corporations are sensibly and continuously reduced all over the year, while for households the reduction is

smaller and lasts until the month of May and a slow recovery appears in June.

For nonfinancial corporations the amount of loans outstanding in November and December 2009 is, respectively, about 163 and 198 billion smaller than the amount outstanding in the preceding month of January and the annual growth rates are always decreasing and become negative in September. For households the amount in August is only 1,4 billion greater than the amount in January while the growth rates are decreasing until April and becoming negative in May and again in August and September. Only in November there is a more sensible growth which bring the outstanding amount to a level higher by 32,4 billion euro than in January, while in December the increase over the preceding January is 44,6 billion.

Even during the year 2010 the outstanding amount of loans accorded to non-financial corporations and firms marked an absolute decrease until April and after June; in the month of December the amount was 20,1 billion euro lower than in the preceding January and 219,2 billion lower than in January 2009, while the % growth rates on the corresponding month of the preceding year remained negative all over the year and marked the maximum negative values (-2,7% and -2,6%) respectively in the months of January and April. In the second half of year 2011 loans to nonfinancial corporations remain constant around 4.750 billion euro and the growth rate over the corresponding period of the preceding year around 1,5% while a reduction in the outstanding amount can be seen since the month of June 2012. A dramatic drop in the growth rate of these loans occurred in this last year, becoming negative in May 2012 and reached the level of -1,8% in October, despite the great amount of liquidity created by the ECB in the first months of 2012.

The outstanding amount of loans to nonfinancial corporations in January 2012, 4.722,4 billion euro, was reduced in October 2012 to 4.638,8 billion euro, that is by around 85 billion while loans to households that in January 2012 were 5.236,3 billion, rose by only 8 billion to 5.244,6 euro in October.

In year 2012 the % rates of growth of L1 and L2, much lower than the rates of growth of M3 (and for L1 even negative since the month of June), show that the main share of liquidity allotted by the ECB to the banking systems has been invested in sectors other than loans to nonfinancial corporations and households.

5. Concluding Remarks

The consequences of the world crisis set a true challenge to some traditional views of monetary theory and policy.

In his Presidential Address delivered at the Eightieth Annual Meeting of the American Economic Association held in Washington, D.C., on December 29, 1967, Milton Friedman, examining which variable should be chosen as a target for monetary policy, said that the monetary authority should guide itself by magnitudes that it can control, not by ones that it cannot control. Among alternative magnitudes that it can control the most appealing guides for policy are exchange rates, the price level as defined by some index and the quantity of a monetary total – currency plus adjusted demand deposits, or this total plus commercial bank time deposits, or a still broader total.

The price level would be the best of the alternatives, but the link between the policy actions of the monetary authority and the price level is more indirect than the link between the policy actions of the authority and any of the several monetary totals; furthermore monetary action takes a longer time to affect the price level than to affect the monetary totals.

He then concluded: "I believe that a monetary total is the best currently available immediate guide or criterion for monetary policy – and I believe that it matters much less which particular total is chosen that that one be chosen" (Friedman 1968, p. 15).

But, as we have seen, a deeper analysis is needed to investigate the relationship between the action of the monetary authority and the level of the monetary totals. In fact the monetary authority can regulate the volume of bank reserves with central banks, not directly the supply of money, be it represented by a narrow or an intermediate or a broad monetary aggregate.

Given the volume of reserves, the size of the supply of money is directly determined by factors affecting the demand for credit by nonfinancial firms and households.

Therefore the great expansion occurred in the amount of bank reserves owing to the highly expansionary policy of the ECB in the years following the financial crisis of 2008 did not entail a corresponding expansion in the supply of money, as measured by the growth of the aggregate M3, nor a sensible growth in the outstanding amounts of credit to nonfinancial corporations and households in the euro area. At the same time this policy

entailed a sensible increase in the demand for assets that can be pledged as collateral for the loans accorded by central banks.

During and after the world crisis the ECB has managed its strategy of monetary policy well beyond the achievement of the statutory target of maintaining price stability, maintaining its expansionary stance even with inflation rates higher than this target.

This policy conducted through nominal interest rates between zero and 1% and real rates even negative, with unlimited allotment of liquidity to the banking systems through temporary and outright open market operations and marginal lending facilities was unable to achieve a true recovery of the real economies and to build a satisfactory "exit strategy" from the crisis, also owing to restrictive fiscal measures, while offering a certain support to the banking systems.

The risk of inflation implied in these policies is due to the probability that the liquidity created by Central Banks may spill out from the financial network and through credits accorded to nonfinancial corporations and households may raise the level of monetary aggregates and the total demand for goods and services; but this effect is, at least in part, avoided because Central Banks recommend and Governments enact restrictive fiscal measures which, at the same time, counterbalance the effects of expansionary monetary policies by reducing the level of money supply and of the demand for goods and services.

More likely expansionary policies of the advanced economies may cause capital flows to emerging market economies (EMEs) which greatly exceed the trade imbalances of these countries, so entailing a rise in the exchange values of their currencies and probably also a thrust to the price level of goods and services and an increase in the rate of inflation.

But these flows, often enhanced by speculative motives, could soon be reversed, so causing a downfall in exchange rates and a general instability of the economies.

Furthermore these policies are doomed to entail the growth of speculative bubbles in the financial markets and in the markets for real estate and for precious metals and in the wholesale markets for some commodities. Prices of assets and interest rates are influenced by the expansion of the monetary base, while prices of consumer goods and services do not show a parallel increase, being tied to a not parallel expansion of the supply of money.

So the cost of the support to the banking systems is paid by the general economy through the reduction of the production of goods and services and

of incomes of firms and consumers, accompanied by a shift of income distribution on behalf of the owners of capital assets.

The expansionary policies conducted by central banks can also hamper the functioning of wholesale money markets.

Both in the Euro Area and in the United Kingdom wholesale money markets were severely affected by the crisis and excessively expansionary monetary policies.

Trading volumes on the unsecured overnight markets have fallen more than half since 2008 (Bank for International Settlements 2012, p. 46).

While nominal interest rates on the money markets have been reduced to historically minimum (often near to zero) levels, the inflation rates, though often also reduced, remain positive, generally above 2%.

So, for some shorter maturities, real interest rates becoming negative hamper the inducement to supply funds on these markets when, after some time, they build a state of negative expectations. Table 11 indicates % nominal and real interest rates for 3-months deposits EURIBOR together with the % increase in the Harmonized Index of Consumer Prices (HICP) for year 2012.

The ECB is so compelled to supply directly an ever greater amount of funds to the banking systems of the euro area while another reason for an expansionary policy is the need to offset the policies followed by the Federal Reserve System, the Bank of England and the Bank of Japan which may induce an overvaluation of the euro and an obstacle to European exports. This consequence is particularly dangerous because in the euro area the monetary policy of the ECB has been faced by restrictive fiscal measures which have reduced the level of the demand for goods and services. So total production and employment in many countries of Europe have been reduced, with the real economy falling in a state of prolonged stagnation and depression.

But fiscal measures that depress total demand appear necessary in order to avoid that liquidity spills out of the financial network into the real economy, so increasing the risk and the rate of inflation. Moreover, interest rates artificially maintained at levels lower than the inflation rates, entail a permanent loss of wealth for investors who own debt securities.

The social cost of a policy aimed to assure a great flow of liquidity to the banking systems of the euro area at very low interest rates directly supplied by the Eurosystem is a reduction in the activity of the money markets and of their efficiency in the allocation of financial funds to the various economic

sectors according to a competitive mechanism, a reduction in total demand for goods and services and so an abiding stagnation of the real economy.

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Dinh Tran Ngoc Huy[*]

THE VOLATILITY OF VIET NAM LISTED BANKING, INSURANCE AND FINANCIAL SERVICES COMPANY GROUPS DURING AND AFTER THE FINANCIAL CRISIS 2007-2009

Abstract

The Viet Nam economy and especially, the stock exchange has been influenced by the global crisis during the period 2007-2009. How much risk for a typical industry in an emerging market such as Viet Nam? For specific industries, such as banking, insurance, investment and security industries, the risk re-analysis and estimation for the listed firms in these industries become necessary.

Firstly, by using quantitative and analytical methods to estimate asset and equity beta of four (4) groups of 32 financial service listed companies in Viet Nam banking, insurance, investment and security industries with a proper traditional model, we found out that the beta values, in general, for most companies are acceptable, excluding a few cases. There are 69% of listed firms with lower risk, among total 32 firms, whose beta values lower than (<) 1.

Secondly, through comparison of beta values among four (4) above industries, we recognized there are still 19% of total listed firms in the above group companies with beta values higher than (>) 1 and have stock returns fluctuating more than the market index.

Finally, this paper generates some outcomes that could provides both internal and external investors, financial institutions, companies and government more evidence in establishing their policies in investments and in governance.

[*] Banking University, HCMC, Viet Nam – GSIM, Intl University of Japan, *Tel*.: +8480908431117; *E-mail address:* dtnhuy2010@gmail.com.

1. Introduction

Firm risk can be used as an investment parameter for investors before they make an investment on either developing or developed financial markets. Hence, we perform a market risk analysis based on asset and equity beta of total 32 listed companies in the category of banking, insurance, investment and security firms. This paper emphasizes on analyzing un-diversifiable risk in the above industry in one of emerging markets: Vietnam stock market during the financial crisis 2007-2009. After the previous published article on estimated beta for listed construction company groups, we will compare the estimated beta results of listed Viet Nam banking institutions to those in its comparative activities such as insurance, investment and security companies to make a comparative analysis and risk evaluation after financial crisis impacts. No research, so far, has been done on the same topic.

This paper is organized as follow. The research issues and literature review will be covered in next sessions 2 and 3, for a short summary. Then, methodology and conceptual theories are introduced in session 4 and 5. Session 6 describes the data in empirical analysis. Session 7 presents empirical results and findings. Then, session 8 gives analysis of risk. Lastly, session 9 will conclude with some policy suggestions. This paper also provides readers with references, exhibits and relevant web sources.

2. Research Issues

We mention a couple of issues on the estimating of beta for banking, insurance, investment/financial service and stock investment companies in Viet Nam stock exchange as following:

Hypothesis/Issue 1: Among the four (4) companies groups, under the financial crisis impact and high inflation, the beta or risk level of listed companies in the stock investment group will relatively higher than those in the rest three (3) industries.

Hypothesis/Issue 2: Because Viet Nam is an emerging and immature financial market and the stock market still in the recovering stage, there will be a large disperse distribution in beta values estimated in these four (4) industries.

Hypothesis/Issue 3: With the above reasons, the mean of equity and asset beta values of these 4 listed group companies tend to impose a high risk level, i.e., beta should higher than (>) 1.

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3. Literature review

Fama, Eugene F., and French, Kenneth R., (2004) also indicated in the three factor model that "value" and "size" are significant components which can affect stock returns. Sabri (2009) concluded that changing of national exchange rate was the most predicting variable to explain the increasing stock volatility and changing of inflation rate was the least predicting variable of stock price volatility in the majority of some developed stock markets. Corradi et al. (2009) pointed the volatility of stock volatility relates to the business cycle. As Luis E. Peirero (2010) pointed, the task of estimating cost of equity in emerging markets is more difficult because of problems such as collecting data in short periods. Then, Velez-Pareja (2011) referred to the lack of inadequate information on the stock market in emerging countries may undermine beta and relevant formulas. Pęksyk, Chmielewski, Panfil and Śledzik (2012) mentioned that the reliability and fitness of calculated betas are relevant to the valuation and investment of investors in emerging markets.

Next, Feng Zhan (2013) found out nations with high individualistic culture have a lower number of synchronized stock price movements and lower levels of stock market volatility. And Pablo Fernandez (2008) also stated that industry betas are very unstable.

4. Conceptual theories

Determinants of Equity and Asset Beta

In financial markets, systematic risk relates to the overall risk of the whole market, is affected by some factors such as: interest rate fluctuations or economic crisis, can not be avoided by diversification, and is measured by a financial metric, beta which is also called systemic risk.

When an investor decides to make an investment in a single company and in a specific stock market, he or she will think of how much risk of the investment. Or what is the beta value of the stock or investment? This research will answer that question.

Of course, risk involves 2 parts: systematic risk (beta) and unsystematic risk, which is business risk or financial risk or diversifiable risk in which investors can reduce it by diversification.

Another application of beta is that it is used in the Capital asset pricing model (CAPM) to value a firm before making an M&A and for pricing assets.

One example to see the meaning of beta is that, if beta of a real estate firm equals to 1,5, the risk of the firm will be 1,5 times higher than the entire market and the return from the investment into this firm might be high equivalently.

5. Methodology

We select the 2007-2009 period as it is the time highlighting impacts from financial crisis. Therefore, we use the data from the stock exchange market in Viet Nam (HOSE and HNX) during this two (2) years to estimate systemic risk results.

Firstly, we use the market stock price of total 32 listed companies in the banking, insurance, investment and security industries in Viet Nam stock exchange market to calculate the variability in monthly stock price in the same period; secondly, we estimate the equity beta for these four (4) listed groups of companies and make a comparison. Thirdly, from the equity beta values of these listed companies, we perform a comparative analysis between equity and asset beta values of these 4 companies groups in Viet Nam. Finally, we use the results to suggest policy for both these enterprises, financial services institutions and relevant organizations.

The below table gives us the number of banking and other financial service (insurance, investment and security) firms used in the research of estimating beta:

Table 1. Descriptive data of listed firms in the research

Market	Listed Banking companies (1)	Listed Insurance companies (2)	Listed Investment & financial service companies (3)	Listed Stock Investment companies (3)	Note (4)
Viet Nam	6	4	7	4	Estimating by traditional method
	3	3	3	2	Estimating by comparative method
Total	9	7	10	6	Total firms in groups: 32

(Note: The above data is at the December 12th, 2010, from Viet Nam stock exchange)

6. General Data Analysis

We analyze the data of a sample of total 32 firms in 4 categories of industries: banking, insurance, investment and security groups, and the mean of equity beta is valued at 0,454 while that of asset beta is about 0,210. These data are acceptable values during the crisis. Furthermore, the sample variance of asset beta is quite low (0,199) which is a good number, while that of equity beta is a little bit higher (0,498). This shows us that the effectiveness of using financial leverage has decreased the systemic risk for the whole industry.

However, the max and min values of beta are still somewhat large. Max equity beta value is up to 2,111 that is a little bit high, compared to max asset beta value is just 1,478 that is acceptable. Looking at the table 3 (below), we can see there is 19%, or 6 listed firms still have beta values larger than (>) 1, whereas there is 69% or 22 firms whose beta values lower than (<) 1 and higher than (>) 0.

Value of equity beta varies in a range from 2,111 (max) to -1,592 (min) and that of asset beta varies in a range from 1,478 (max) to -1,143 (min).

Some companies still has larger risk exposure than most of the others. There are 4 listed companies whose betas are lower than (<) 0, which means the stock return moves in a opposite direction to the market index.

Next, Asset beta max value is 1,478 and min value is -1,143 which show us that if beta of debt is assumed to be zero (0), the company's financial leverage contributes to a decrease in the market risk level.

Lastly, we can see the relatively high difference between max equity and max asset beta values, which is about 0,633, whereas there is a smaller difference between equity and asset beta variance values which is just 0,299; so, there is certain impact on systemic risk of certain firms in term of using leverage while it indicates for most of firms that financial leverage can enable them to reduce market risk. And there is not quite big effect from financial leverage on the gap between company's beta variance values.

Table 2. Estimating beta results for Four (4) Viet Nam Listed Banking and Other Financial Service Companies Groups (as of Dec 2010)

Statistic results	Equity beta	Asset beta (assume debt beta = 0)	Difference
MAX	2,1110	1,4780	0,6330
MIN	-1,5920	-1,1430	-0,4494
MEAN	0,4540	0,2100	0,2449
VAR	0,4981	0,1990	0,2991

Note: Sample size : 32

Source: Viet Nam stock exchange data

Table 3. The number of companies in research sample with different beta values and financial leverage

Equity Beta	No. of firms	Financial leverage (average)	Ratio
<0	4	50,70%	13%
0<beta<1	22	54,49%	69%
Beta > 1	6	52,17%	19%
total	32	88,60%	100%

Asset Beta	No. of firms	Financial leverage (average)	Ratio
<0	4	50,73%	13%
0<beta<1	27	54,49%	84%
Beta > 1	1	29,98%	3%
total	32	90,50%	100%

7. Empirical Research Findings and Discussion

A - Banking listed companies group

In the crisis 2007-2009, the market for these institutions still exists and grows, but has certain difficulties. The rising inflation and rising lending interest rates and higher opportunity costs makes input materials or production costs increasing. So, the market for borrowing firms has been affected because selling prices increase.

The table 4 below shows us the research of 9 listed firms in this category during the above period. In general, the mean of equity beta and asset beta are 0,493 and 0,057, accordingly. These values are good numbers in term of indicating a low and acceptable un-diversifiable risk. The market demand for financial services is still high.

Besides, the variance of equity and asset beta of the sample group equals to **0,1316 and 0,0027 accordingly** which are lower than the variance of the entire sample equity and asset beta of **0,49** and **0,199**. The effect from

financial leverage makes these beta values fluctuate a little bit less than the sample beta mean.

We might note that equity beta values of 9 firms in this material category are a little lower than those of firms in the rest two (2) groups: finance and stock investment, but higher than that of insurance firms. This might be considered as one characteristic of these industries. Among four (4) industries, the systemic risk of banking group companies is a bit higher than that of insurance group.

Besides, the estimated equity beta mean is **0,493** and sample variance is **0,1316**, which is not supporting our 2nd research hypothesis or issue that there would be a large disperse distribution in beta values estimated in this industry as well as our 3rd research hypothesis or issue that the mean of equity and asset beta values of these listed companies tend to impose a high risk level or beta should higher than (>) 1.

Table 4. Estimating beta results for Viet Nam Listed Banking Companies (as of Dec 2010)

Order No.	Company stock code	Equity beta	Asset beta (assume debt beta = 0)	Note	Financial leverage
1	ACB	0,850	0,083		90,3%
2	CTG	0,415	0,024		94,3%
3	EIB	0,629	0,145		77,0%
4	HBB	0,135	0,016	SHB as comparable	88,2%
5	MBB	0,081	0,009	STB as comparable	89,3%
6	NVB	0,021	0,003	HBB as comparable	86,4%
7	SHB	1,011	0,113		88,8%
8	STB	0,826	0,089		89,3%
9	VCB	0,473	0,030		93,6%

Note: Raw data, not adjusted

Source: Viet Nam stock exchange data

Table 5. Statistical results for Vietnam listed Banking companies

Statistic results	Equity beta	Asset beta (assume debt beta = 0)	Difference
MAX	1,0110	0,1450	0,8666
MIN	0,0210	0,0030	0,0184
MEAN	0,4930	0,0570	0,4366
VAR	0,1316	0,0027	0,1289

Note: Sample size: 9

B - Insurance listed companies group

In an emerging market such as Viet Nam, the market for insurance firms is definitely potential because of the public need for such necessary vital products and though it may be affected by impacts from the financial crisis.

The Table 6 below shows us the equity and asset beta mean of 7 listed insurance companies, with values of -0,157 and -0,104, accordingly. This result, which means the risk is low and negative because there are 4 among 7 firms with beta < 0. We note that equity and asset beta var have acceptable values of 1,15 and 0,4. This indicates the good effect from using financial leverage.

Beside, this is the group with the highest equity beta var of 1,15.

Please refer to Exhibit 2 for more information.

Table 6. Statistical results for Vietnam listed Insurance companies

Statistic results	Equity beta	Asset beta (assume debt beta = 0)	Difference
MAX	1,2550	0,8030	0,4519
MIN	-1,5920	-1,1430	-0,4494
MEAN	-0,1570	-0,1040	-0,0532
VAR	1,1508	0,4057	0,7451

Note: Sample size : 7

C - Investment & financial service listed companies group

Among 4 groups, this is the group with the highest number of listed firms (sample size = 10) and with the highest equity beta value of about 0,81. However, the asset beta mean of about 0,407 is a little lower than that of stock investment industry. The using of leverage has influenced these firms' risk a bit more than the stock investment group.

Different from firms in the insurance industry, 10 listed firms has lower equity and asset beta var values, estimated at 0,37 and 0,19, which implies there is a more concentration in market risks among firms in this industry. The equity and asset beta values are distributed in a proper range, from 0,281 to 2,111, and from 0,056 to 1,478 which are acceptable, esp., asset beta values are quite low, indicating the effectiveness of using financial leverage.

Please refer to Exhibit 3 for more information.

Table 7. Statistical results for Vietnam listed Investment & Financial service companies

Statistic results	Equity beta	Asset beta (assume debt beta = 0)	Difference
MAX	2,1110	1,4780	0,6330
MIN	0,2810	0,0560	0,2251
MEAN	0,8130	0,4070	0,4059
VAR	0,3748	0,1945	0,1803

Note: Sample size: 10

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D - Stock investment listed companies group

Many firms in this category have difficulties in their operation during these years. Different from firms in the other three (3) industries, 6 listed stock investment firms has the lowest value of equity beta var of 0,03 and asset beta var of 0,05, showing market risk with less dispersion.

Max beta values of 0,758 and 0,747 are the low and acceptable values with the small difference of beta means of 0,0367. This indicates a less impact from using leverage in level of market risks among firms in this industry (compared to 0,4059 in the investment and finance group).

The asset beta mean value is 0,476 (the highest) and equity beta mean value is 0,51 (the 2nd highest in 4 groups) shows the financial leverage has less impacts on market risk exposure in this category during the crisis period, compared to the other industries.

Please refer to Exhibit 4 for more information.

Table 8. Statistical results for Vietnam listed Stock Investment companies

Statistic results	Equity beta	Asset beta (assume debt beta = 0)	Difference
MAX	0,7580	0,7470	0,0109
MIN	0,2950	0,1660	0,1289
MEAN	0,5130	0,4760	0,0367
VAR	0,0341	0,0497	-0,0156

Note: Sample size: 6

Comparison among 4 groups of banking and other financial service companies

In the below chart, we can see among the 4 groups, equity beta values of the banking and insurance groups are the lowest (0,49 and -0,157) and asset beta values of these groups are also the lowest (0,06 and -0,1), while equity beta mean of investment and finance group is the highest and asset beta mean of the stock investment is the highest. Assuming debt beta is 0,

financial leverage has helped many listed firms in these industries lower the un-diversifiable risk.

Additionally, we could see the asset beta mean values of all 4 groups have not big difference and acceptable, except for the insurance group. Therefore, it also rejects our 3rd hypothesis that the mean values of equity/asset beta of all 4 groups impose higher risks.

Next, we can recognize from the chart that, the risk in the stock investment industry higher than those in the other industries. So, it supports our 1st hypothesis.

Last but not least, from the calculated results, variance of asset beta in the financial service industries are low (vary in range of 0,003 – 0,41). This also rejects our 2nd hypothesis.

Figure 1. Statistical results of four (4) groups of 32 listed VN banking and other financial service firms during/after the crisis period 2007-2011
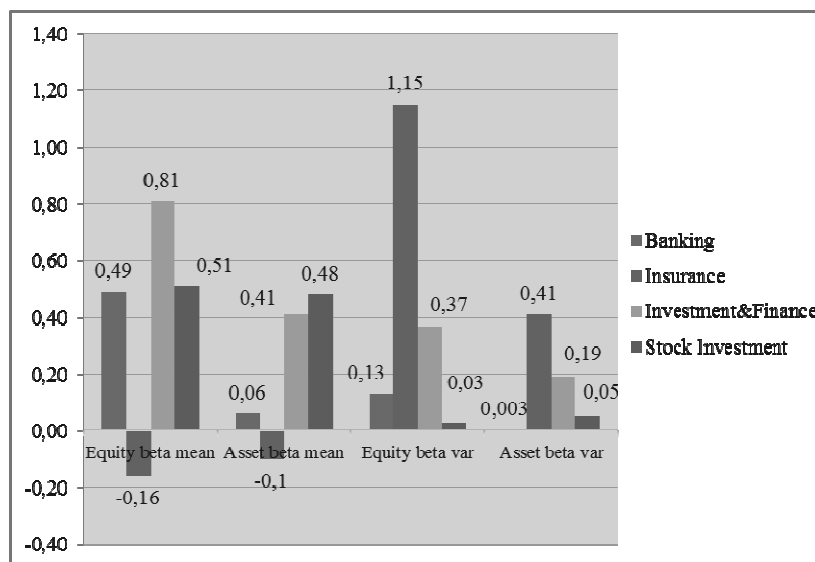
8. Risk analysis

Generally, the financial crisis will affect the whole economy and slowdown the speed of ODA and FDI capital invested into financial service industries in Viet Nam. Additionally, it has some negative impacts on Viet Nam stock market which is in the down turn. And it also might have indirect impacts on banking industry through macro factors such as interest rates, exchange rates. Form financial service industry and banking industry, the level of crisis impacts can move to other markets such as real estate market.

However, there are positive efforts from market participants. For example, banks and insurance firms have created many more joint products and services. This enables companies to enhance their brand names.

9. Conclusion and Policy suggestion

Banking industry

This is the group with the 2nd highest number of listed companies (9 firms). Even though beta mean values are fine (0,49 and 0,06 accordingly), this is the industry which has both the 2nd lowest asset beta mean values and the lowest asset beta var (see chart 1). During the crisis, this industry has lower market risk and beta values of firms in the group are less fluctuated.

After increasing rates period, financial services industries, the government and central banks have certain efforts and proper policies to support businesses and internal investors, and stabilize inflation.

Insurance industry

Generally speaking, this is the industry which has the highest values of equity and asset beta var, among 4 groups (0,13 and 0,003 accordingly). There are 4 over 7 firms whose beta values are negative (<0). The market is established but some movements of firm stocks are in an opposite direction to the whole market.

Investment & Financial service industry

Through our comparative analysis on asset beta values, this is the industry which has the highest number of firms (10 firms) and which has the highest

equity beta mean and the 2nd highest asset beta mean (0,81 and 0,41 accordingly). But it has lower market risk exposure than that of the insurance industry when we consider values of equity beta mean, or asset/equity beta var.

Stock investment industry

In our comparative analysis on asset beta values, this is the industry whch has the smallest number of companies (6 firms) and which has the lowest values of equity beta var of 0,03 and asset beta var of 0,05. This shows us the lower level of dispersion of market risk compared to other industries although the leverage tends to expand the risk exposure. On the other hand, asset beta mean value of 0,48 ranks the highest and equity beta mean of 0,51 ranks the 2nd highest among 4 groups. When we consider impacts of financial leverage, market risk exposure and dispersion is lower than that of the other three (3) industries. But the leverage has more effects on the investment and financial service industry when we note the equity/asset beta mean values of these 2 groups.

In general, our empirical findings state that they are not in favor of our 2nd and 3rd hypotheses or research issues but support our 1st hypothesis.

In short, though Viet Nam is an emerging market with growing financial system, the equity beta values estimated are at acceptable level with 69% firms in the research sample while just a few companies' beta values are risky (about 19% firms). In term of asset beta values, there are 84% of firms whose beta in a range 0–1, and only 3% or 1 firm whose beta > 1.

Additionally, it indicates the higher the using of financial leverage, the lower the beta values. In reality, there are 69% of financial service firms (22 among 32 firms) which has 0<beta<1 in this research sample. If used effectively, using leverage can be good for risk management.

Furthermore, if we compare these data and values to those of construction and real estate firms, and to those of computer and electrical companies in our previous research (see exhibit 5 and 6), we might see that in here, the asset beta mean of stock and finance groups can be a little bit higher than those of computer and electrical firms but those of banking and insurance could be lower, while equity beta mean of these firms are lower than those of construction and real estate firms and while the impacts from the crisis happens on the overall market. So, the leverage becomes more meaningful and the crisis might have less influence on the firms in the above research.

Finally, this paper suggests implications for further research and policy suggestion for the Viet Nam government and relevant organizations, economists and investors from current market conditions.

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Exhibit

Exhibit 1 – Interest rates, Inflation, GDP growth and macroeconomics factors

Year	Basic rates	Lending rates	Deposit rates	Inflation	GDP	USD/VND rate
2012	n/a	12%-15%	9%	6,81%	5,03%	20.828
2011	9%	18%-22%	13%-14%	18%	5,89%	20.670
2010	8%-9%	19%-20%	13%-14%	11,75% (Estimated at Dec 2010)	6,5% (expected)	19.495
2009	7%	9%-12%	9%-10%	6,88%	5,2%	17.000
2008	8,75%-14%	19%-21%	15%-16,5%	22%	6,23%	17.700
2007	8,25%	12%-15%	9%-11%	12,63%	8,44%	16.132
2006	8,25%			6,6%	8,17%	
2005	7,8%			8,4%		
Note	Approximately (2007: required reserves ratio at SBV is changed from 5% to 10%) (2009: special supporting interest rate is 4%)					

Source: Viet Nam commercial banks and economic statistical bureau

Exhibit 2 – Estimating beta results for Viet Nam Listed Insurance Companies (as of Dec 2012)

Order No.	Company stock code	Equity beta	Asset beta (assume debt beta = 0)	Note	Financial leverage
1	BVH	0,485	0,143		70,5%
2	PVI	1,006	0,436		56,6%
3	ABI	-1,592	-1,143		28,2%
4	BIC	-0,627	-0,169	ABI as comparable	73,0%
5	BMI	1,255	0,803		36,0%
6	PGI	-0,828	-0,389	ABI as comparable	52,9%
7	PTI	-0,802	-0,411	ABI as comparable	48,8%

Source: Viet Nam stock exchange data

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Exhibit 3 – Estimating beta results for Viet Nam Listed Investment &
Financial service Companies (as of Dec 2012)

Order No.	Company stock code	Equity beta	Asset beta (assume debt beta = 0)	Note	Financial leverage
1	AGR	0,597	0,074		87,6%
2	APG	0,334	0,305	CLS as comparable	8,8%
3	APS	0,372	0,202		45,7%
4	AVS	0,281	0,205	CLS as comparable	27,2%
5	BSI	0,491	0,056	AGR as comparable	88,5%
6	BVS	2,111	1,478		30,0%
7	CLS	0,341	0,174		49,0%
8	CTS	1,073	0,703		34,5%
9	PVF	1,523	0,179		88,2%
10	VNR	1,002	0,692		31,0%

Source: Viet Nam stock exchange data

Exhibit 4 – Estimating beta results for Viet Nam Listed Stock Companies (as of Dec 2012)

Order No.	Company stock code	Equity beta	Asset beta (assume debt beta = 0)	Note	Financial leverage
1	ASIAGF	0,350	0,166	MAFPF1 as comparable	52,5%
2	MAFPF1	0,489	0,487		0,5%
3	PRUBF1	0,295	0,294		0,3%
4	VFMVF1	0,758	0,747		1,4%
5	VFMVF4	0,701	0,691		1,4%
6	VFMVFA	0,484	0,471	MAFPF1 as comparable	2,7%

Source: Viet Nam stock exchange data

Exhibit 5 – Statistical results of four (4) groups of 64 listed VN computer and electrical firms during/after the crisis period 2007-2009
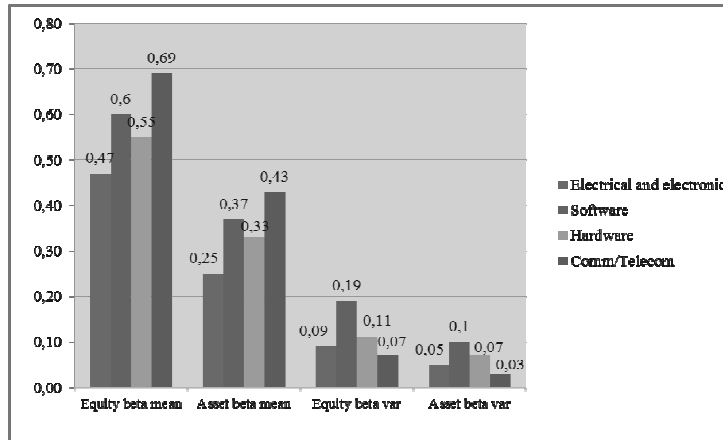

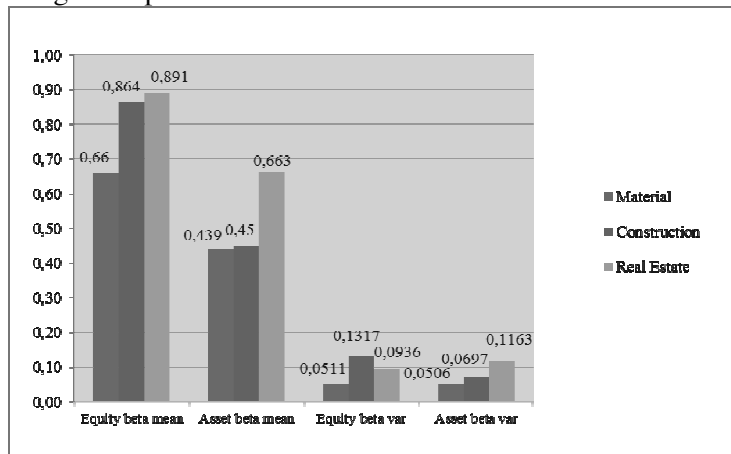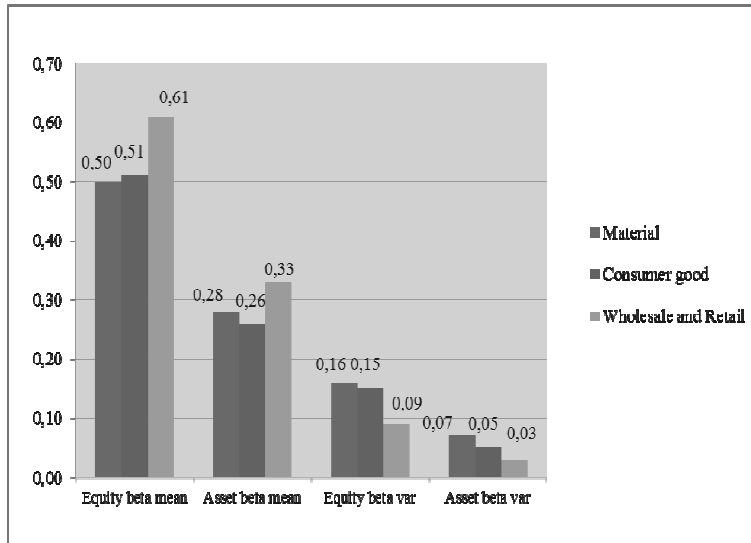Exhibit 6 – Statistical results of three (3) groups of 103 listed construction firms during crisis period

Exhibit 7 – Statistical results of three (3) groups of 228 listed VN consumer good firms during/after the crisis period 2007-2009

Flavio Felice[*] - Antonio Magliulo[**] - Johann Spitzer[***]

LATIN AMERICA AND EUROPE TOWARDS A MUTUAL UNDERSTANDING.

ECONOMIC CULTURE AND POLITICAL CONSTITUTION IN THE EXPERIENCE OF PERU

Abstract

In recent years Europe and Latin America have increased their relationships in a multidimensional spectrum where economic, social and cultural interactions are strengthening. Concrete platforms of integration and collaboration between both regions are emerging. In this context, Peru is (again) becoming a central player in the Latin American history, particularly due to its leadership role in the Pacific Alliance initiative, which represents the most ambitious integration initiative in Latin America. Considering this, we think it appropriate to initiate with Peru a process of mutual understanding. The work analyzes the "economic constitutions" of the European Union and Peru. The analysis shows that the principle of subsidiarity and the other underlying principles of the social market economy appear in both economic constitutions as breakthrough elements for a deeper integration and cooperation between the two regions.

[*] Pontifical Lateran University of Rome, Piazza San Giovanni in Laterano 4, 00120 Città del Vaticano, Tel.: +39-06-69895626; *E-mail address*: felice@tocqueville-acton.org.

[**] Rome University of International Studies, Via Cristoforo Colombo 200, 00145 Rome (Italy), Tel.: +39-06-57100241; *E-mail address*: antonio.magliulo@unint.eu.

[***] University Sedes Sapientiae of Lima, Av. Salaverry 740, Jesús María, +43-05288-72369, Lima 11, Peru, *E-mail address*: johann.spitzer@gmail.com.

1. Introduction

Latin America and the European Union have recently signed different strategic agreements to support and improve economic cooperation and regional integration, where new platforms of collaboration at all levels (supra-national, national, sub-national) are arising. The European Union and Latin American and Caribbean Foundation (EU-LAC) is a fascinating case, where sub-national entities of both continents are exploring new forms of cooperation.

In 2013 a Free Trade Agreement between Peru and European Union became in force, representing a remarkable expression of increasing collaboration between Europe and a country that has been historically considered as the "core" of the Andean Community and currently is recognized as one of the leader of Pacific Alliance, which represents the most ambitious integration initiative in Latin America, involving four countries: Peru (promoter of the initiative), Chile, Colombia and Mexico. In such context it is important to trigger a process of mutual understanding between the two regions.

Andean countries and the European Union are experiencing a key phase of changing. In the former, it has been observed a strong social stress due to the increasing debate on political constitutions, especially regarding the legal framework which affects the real economy. The latter is trying to implement a strategy for a smart, sustainable and inclusive growth.

The aim of the paper is to give a contribution to the mutual understanding between the two regions. In particular we intend to compare the economic constitutions of Peru and Europe with the purpose to assess some similarities and divergences.

We have faced some inner difficulties. Peru is a national State, Europe is a supranational entity. Moreover the concept of "economic constitution" is a controversial issue. Here, economic constitution refers to the body of rules which determine goals and means of the intervention of public authorities in the economic sphere.

The paper is organized into three parts. In the first, we will present a brief

sketch of the so-called Social Market Economy model, which seems to have inspired the two constitutions. In the second, we will describe the basic features of the economic constitution of Europe. In the third, we will focus on the economic constitution of Peru trying to show the main schools of economic thought behind the designed economic system. In the conclusions, we will try to assess the main similarities and differences between the two constitutions and to evaluate if the Social Market Economy could be a common model to combine economic growth and social justice and to foster cooperation between the two regions[1].

2. The Theory of Social Market Economy

The confrontation with the competitive market issues under an "institutional approach" was the most important contribution given by ordoliberals: the competition order is in itself a "public benefit" and as such should be protected. This constitutional perspective of the market, approaches the ordoliberals of the Freiburg School and the institutional research by James Buchanan, who has universalized the liberal ideal of voluntary cooperation, transferring it from market decisions to institutional choices (see Buchanan 1977, p. 5).

First of all, our reference to the social market economy meets an academic (more than political) experiment that was initiated in the second half of the Thirties in Nazified Germany as an experiment that took the name of "Ordoliberalism". Among the main representatives who contributed to the development and dissemination of that school of thought there were economists such as Walter Eucken, Alexander Rüstov, and Wilhelm Röpke and jurists such as Hans Grossman-Dörth and Franz Böhm (see Habermann 2006); the latter, together with Eucken, were the coeditors of the "Ordo" journal. In the first volume of their publication, *Ordnug der Wirtschaft* (1936), Böhm, Eucken and Grossman-Dörth drafted a programmatic introduction in which they articulated their firm stance against the persistent legacy of the German Historical School of Economics of Gustav Schmöller and they also asserted the general principle that "all the practical political-legal or political-economic issues had to be linked to the notion of economic constitution", in the conviction that the interrelationship between law and

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[1] On the strategic agreement between Andean Community and European Union, see European Commission (2007).

economics is "crucial". In the essay/manifesto of 1936, named "Our Task", the fathers of ordoliberalism pointed out: «Law and political economy were constitutive forces that exercised a remarkable influence – for instance, in the reconstruction of the legal and economic system that took place in all civilized countries at the end of the 18th century. Only during the course of the 19th century and at the beginning of the 20th century they lost their prominence» (Böhm, Eucken and Grossmann-Dörth in Peacock and Willgerodt 1989, p. 15). The Historical School of Economics, as Eucken wrote in the 1951 edition in his *Foundations of political economy* (1939), is a theoretical in the sphere of political economy and arbitrary in the sphere of economic policy: «Menger maintains that the historical economist must find out the "concrete relationships between facts". But this is exactly what a historian cannot do. How can he establish through his historical method the connections that exist between price drops, unemployment and output decline and the concrete causes of all these phenomena?» (Eucken 1951, p. 51). According to Eucken, the relations that the "historical economist" discerns "are still unknowable through his methods". In other words, at the heart of the concept of "Ordo" there is a free competitive market, essential so as to ascertain a freedom which is not only economic. Without regulation which conforms to such principles, the market cannot work appropriately or sustain economic growth while providing the base for equitable distribution.

After the Second World War, the Ordoliberal program offered the theoretical foundation for the development of the so-called "social market economy".

The social market economy and its underlying theory, ordoliberalism, present themselves like an alternate and systematic approach leading up to the *Ordnungstheorie* and to the *Ordnungspolitik* (Vanberg 2006, p. 916). Unlike the authoritarian understanding of the term "order", for "ordoliberals" the notion refers to *coordination* of individual plans, a decentralized coordination of economic activities in a general framework of rules of the game, and refuse to *subordinate* economic activities to a central authority[2]. This is the reason why we believe, like Vanberg does, that the founders of ordoliberalism emphasized the role of the rules of the game, as the main means to attempt to put in place an economic policy capable of

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[2] For an analysis of the debate between ordoliberals and Austrian economists, see Felice (2008, pp. 57-62). See also Bladel (2005, p. 22). For a wide overview of the Austrian critique on the ordoliberal perspective, see Sally (1998).

improving economy, i.e. to put in place "correct economic institutions" (Vanberg 2006, p. 917). For our authors the combination of law and economic analysis is a prerequisite to create what they called the social market economy, i.e. the development of an economic constitution attempting to improve the economic system in an *indirect manner*, revising the rules of the game, in sharp contrast with an interventionist economic policy. Razeen Sally writes: «It's up to the State to put in place and maintain the institutional framework of a free economic order, but it must not intervene in the mechanisms of the competitive economic process: here is the essence of the *Ordnungspolitik*» (Sally 1996, p. 8). All of this in the conviction that the establishment of such an institutional and legal framework, of an effective market order, could have enabled to solve of the social issues of the 19th century. In 1936 Eucken, Böhm and Grossmann-Dörth themselves, in the "Ordo" manifesto, stated that: "We seek to create an economic and social order ensuring, at the same time, the proper functioning of the economic activity as well as decent and humane living conditions. We are in favour of a competitive economy, since it allows to achieve these goals. And we can also say that this end cannot but be accomplished by this means. Competition is a means, and not an end in itself" (Böhm, Eucken and Grossman-Dörth in Peacock and Willgerodt 1989, p. 15).

In the aim to identify a possible "ideal profile" of what we mean for social market economy, a remarkable contribution is considered the essay "Economic and Social Order". Unpublished until 1979, it was written in 1943 at the request of the Lutheran pastor from Berlin, Dietrich Bonhöffer, which formed part of a group of studies on the principles that the Christian order should prevail in Germany and coup against Hitler[3]. A copy of the manuscript was found among the papers of one of the organizers of the 1944 attack against Hitler who was known to be supported by Bonhöffer. Diezte and Lampe were arrested by the Gestapo, Eucken was subjected to harsh interrogation in which were not found proofs that he participated in drafting

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[3] The essay was published in the volume: *Der Stunde Null. Die Denkschrift des Freiburger "Bonhöffer-Kreises" politische Gemeinschaftsordnung. Eine Versuch zur Selbstbestimmung des christliche Gewissens in den politischen Noten unserer Zeit*, with an introduction by Helmuth Thielicke and an afterword by Philipp von Bismark, Tübingen, Mohr Siebeck 1979. In order to have a resume on this political affair, see Forte and Felice (2010).

the document; therefore he was not imprisoned.

Below, is presented a short synthesis of the essay that might be used as a guide in order to understand a possible social market economy ideal model (Forte and Felice 2010, pp. 42-43):

•   There is no chance to pursue collectively a rational new order, without establishing an economic constitution that meets the need for ethical principles.

•   At the basis of this view there is necessarily the principle of competition.

•   It should be based on the responsibility of economic actors and therefore on the freedom of the market and price.

•   Therefore, the State must put clear rules in order to ensure equality between the various economic operators. Among these, we mention the control of concentrations of economic powers, in particular, endanger the middle class. Similarly, the State should defend and promote family savings and "self consumption"[4].

•   Only if there is a clear failure of the market to function in a satisfactory competitive way, the State will assume the exercise of public enterprise or regulate those private, in a market consistent way.

•   Monetary policy needs stability, preferably by the link to the gold standard.

•   Fiscal policy should be based on the prohibition of important debt.

•   Right prices and wages, as a result of a genuine competitive process, are the best protection against unemployment. The task of the State is only to prevent the "exploitative wages".

•   Social policy should not consist merely in the sum of uncoordinated individual measures, but must ensure a true community of men. State responsibility is to create the conditions.

•   The economic system must be protected by constitutional rules which clearly fix the fundamental principles.

Some jurists have affirmed that the economic ordoliberalism theory, the social market economy, will be the foundation of the European Community (De Benedetto 2000, pp. 18-19).

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[4] Here is a clear reference to the small peasant property and the ownership of the factory workers of houses with small farms that allow them a certain degree of economic autonomy.

3. The Economic Constitution of Europe

Europe is not a Super-State. It is neither a classical Federation nor a Confederation. Europe has not a "formal constitution", since the Constitutional Treaty, approved in 2004, has not been ratified.

What is Europe therefore?

As Manuel Barroso once said, it is "a very special construction unique in the history of mankind". Europe is a Union, "on which the Member States confer competences to attain objectives they have in common" (Lisbon Treaty, art. 1). The European Constitution is a "consolidated version" of several treaties discussed, approved and revised over time. In this sense, it is a "material constitution" able to change and orient the law of the Member States in many fields, including economy[5].

In order to understand the meaning of the current economic constitution of Europe we have to briefly look at the past[6].

The ancient idea of a unified Europe re-emerged during WWII. The aim glimpsed by visionary people like Altiero Spinelli was to prevent a new great war. The question faced after the war was: how can we unify Europe?

Economists and politicians elaborated two alternative strategies. One was named "functionalism". According to the Rumanian economist Mitrany and the French politician Monnet, the first step towards a unified Europe was meant to be opening the markets. A progressive economic integration would have called a model of political unification in the end. Economy first, policy later.

The alternative approach was "federalism". According to some economists like Robbins and Einaudi, and some politicians like Spinelli, the first step should have been to set up a federate state (weak or strong). Only a government would have been able to manage a complex process of economic integration. Policy first, economy later (see Magliulo 1994).

The functional approach prevailed. The date of birth of modern Europe can be considered April 16th, 1948 when in Paris the Organization for European Economic Cooperation (OEEC) was established in order to manage the aid of the so-called Marshall Plan. Other steps in the same

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[5] On European economic constitution we only mention Joerges (2004, 2011), Joerges and Rödl (2004). On the question of democratic deficit, see Majone (2009).

[6] On the history of European constitution from Rome to Lisbon, see Streit and Mussler (1995), Weiler (1990), Schiek, Liebert and Schneider (2011).

direction followed. In 1950 the European Payments Union (EPU) was set up, in 1952 the European Coal and Steel Community (ECSC) was established and in 1957 six European countries (France, West Germany, Italy, Belgium, Netherlands, Luxembourg) signed the Treaty of Rome which created the European Atomic Energy Community (Euratom) and, above all, the European Economic Community (EEC). The Treaty of Rome accelerated and deepened the process of economic integration. It designed a partial economic union: in addition to pursue a custom union, it foresaw free mobility of labor and capital and a common policy in the agriculture sector. There was no mention of any monetary union: at the time, the relationships among western currencies were ruled by the Bretton Woods Agreements.

At the beginning of 1970s a severe crisis occurred. On 15th August 1971, US President Richard Nixon declared the end of gold convertibility for the dollar, thereby decreeing the end of the international economic order established at Bretton Woods. In November 1973, the countries of the OPEC decided to quadruplicate the price of oil, increasing it from 3 to 12 dollars a barrel. The world was struck by the strange new crisis of stagflation. The European construction stopped. But it was just a moment. Then the construction restarted. In 1973 Britain joined the European Community triggering a process of enlargement, and in 1979 a European Monetary System (EMS) was established. In 1985 the Single European Act (SEA) was signed. The aim was to establish the European Single Market by the end of 1992 reinforcing the fundamental four freedoms promised by the Treaty of Rome: free movement of goods, services, people and capital.

Berlin, November 9th, 1989: the wall, and the communism, fall. Europe starts to change. From one hand, it looks at the West imagining a further enlargement. From the other, it looks inside itself aware that a single market can only work together with the Economic and Monetary Union. The so-called "Impossible Trinity Theorem" shows in fact that it is impossible to have at the same time fixed exchange rate, full capital mobility and national monetary policy independence. The European Community wanted to maintain the first two targets in order to build a single market. Therefore, it had to renounce to the last target (see Baldwin and Wyplosz 2006, p. 335).

A second huge phase of political unification, still open, starts with the signature of both the Maastricht Treaty (1992) and the Amsterdam Treaty (1997).

The aim was to introduce a single currency (Euro) as well as to begin a common monetary and fiscal policy. The result is a transfer of economic

sovereignty from national states to European bodies.

Some scholars have argued that, after Maastricht, Europe became a "market without State" and a "Union without Constitution".

They are right. However, the two treaties introduce a body of rules (a material constitution) able to determine goals and means of the *economic governance*. The aim is to extend both economic freedoms and social rights or, with the words of the Treaty of Amsterdam (art. 2), "to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development". The way is an active economic policy based on three key principles. The first, "the principle of an open market economy with free competition" (Maastricht Treaty, art. 3A). It implies to renounce any kind of protectionism, either internal or external. The second, the principle of "stable prices, sound public finances and monetary conditions and a sustainable balance of payments." (*Ibidem*). It implies that the common monetary policy will be oriented to the target of low inflation (around 2%) while the single national governments will be able to run a deficit spending policy only inside of quantitative limits (Stability and Growth Pact). The last one, the "principle of subsidiarity", according to which in "areas which do not fall within its exclusive competence, the Community shall take action … only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community." It implies to renounce any kind of strong central authority.

It seems the way traced by the classical constitutions to solve the unsettled question of combining economic freedoms and social rights: the free market remains the best, or only, way to reach that destination. However, the two treaties committed public authorities (national and Europeans) many "common actions" unusual for a liberal State in order to enhance social cohesion. The material constitution of Europe seems, that is, to depict an active economic policy[7].

At the beginning of the new Millennium, Europe tries to write a formal Constitution. After the Special European Council held in Lisbon in March 2000 with the aim of launching a new strategy of growth and social cohesion (the so-called Lisbon Strategy), the European Council met again in Laeken

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[7] One key question concerns the compatibility between the European constitution and national constitutions, i.e. Italian: see Magliulo (1999, 2010).

in December 2001 in order to call a "Convention on the Future of Europe" entrusted to write a Constitution. The Convention held its inaugural session on 28th February 2002. During the debate, Joschka Fischer and Domenique Villepin proposed a joint motion concerning the idea of "social market economy" (Joerges 2011, p. 9). The "Treaty establishing a Constitution for Europe" (TCE) was signed on 29th October 2004 by representatives of 25 member states. The article I-3 listed the "Union's objectives". There you can read: "The Union shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance."

For the first time, the expression "social market economy" is explicitly adopted by European Union.

The Treaty was however rejected by French and Dutch voters in mid-2005 and the process of ratification stopped. Then, the Intergovernmental Conference decided to approve an international agreement to amend previous basic rules. The Lisbon Treaty was signed by the 27 EU member states on 13th December 2007, and entered into force on 1st December 2009. It introduces significant changes in fields concerning foreign affairs, political power of citizens and environment. The most important change concerning "economic constitution" is that it adopts the principle of social market economy introduced by the Convention. This is the entire article 3.3:

"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance.

It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child.

It shall promote economic, social and territorial cohesion, and solidarity among Member States.

It shall respect its rich cultural and linguistic diversity, and shall ensure that Europe's cultural heritage is safeguarded and enhanced."

Someone could observe that it is only an emphatic declaration. Maybe it is true, like for any other "constitutional principle". But in March 2010 the

European Commission approves a new strategy for the next ten years: "Europe 2020". The idea of a "social market economy" becomes much more workable. The aim is to promote a growth "smart, sustainable and inclusive". It is not just an emphatic intention. The European Commission intends to achieve some measurable targets in ten years. They wrote:

"The EU needs to define where it wants to be by 2020. To this end, the Commission proposes the following EU headline targets:

– 75% of the population aged 20-64 should be employed.

– 3% of the EU's GDP should be invested in R&D.

– The "20/20/20" climate/energy targets should be met (including an increase to 30% of emissions reduction if the conditions are right).

– The share of early school leavers should be under 10% and at least 40% of the younger generation should have a tertiary degree.

– 20 million less people should be at risk of poverty" (European Commission 2010, p. 3).

The way to achieve these goals is not only a single and free market. The Commission proposes "seven flagship initiatives to catalyse progress under each priority theme". They regard: innovation, education systems, digital information, energy efficiency, industrial policy, new skills, and a platform against poverty.

These goals and means are the real content of the current European Social Market Economy: "Europe 2020 sets out a vision of Europe's social market economy for the 21st century." (*Ibidem*)

4. The Economic Constitution of Peru

Peru is a particularly complex country due to its geographic location in Latin America and its history. It is considered the cradle of the South American civilization, compared to the Mexican experience in North America, hosting a great variety of cultures. Its geographic location, in the center of the Andes which extend from Chile to Venezuela, configures an intricate economic and a cultural space which in many aspects represent the Andean reality.

In this context, the study of its economic constitution represents a valid effort to understand the reality that has shaped its economic development. The importance of this analysis is confirmed by the recent political situation in Peru, which placed in the center of the political debate, the need to return to the Constitution of 1979, leaving out the current 1993 Constitution.

The extreme importance of this debate was (and returns…) due to the fact that the main economic agents see in the 1993 Constitution a key element in the Peruvian economic and political stability, which has significantly contributed to strengthen a dynamic of growth widely recognized. However, the Nationalist Party (currently the ruling party) during the presidential campaign expressed that the current constitutional does not guarantee an "inclusive development", leaving great majority of the population outside the benefits of economic growth. Consequently, they consider that the present constitution substantially limits the role of central government as an active promoter of economic and social development. Such expressions and recent political orientations in such direction implied that the debate of changing the current Peruvian constitution is still open; nonetheless most political forces and the opposition reject this intention due the instability (economic and social) that would generate.

Under these considerations, it is fully justified the analysis of the two constitutions under discussion (1979 and 1993). The starting point of our analysis intents to verify if both constitutions converge or diverge from a "social market economy". This aspect is particularly important because, despite the differences in the debate, curiously, their both "constitutional texts" (European and Peruvian) express explicitly their desire to set up a "social market economy". The Peruvian constitutional law state (both 1979 and the current 1993):

"Private enterprise is free. It is exercised within a social market economy. The state encourages and regulates its practice in order to harmonize it with the public interest." (1979 Constitution, Art. 115)

"Private enterprise is free. It is exercised within a social market economy. Under this regime, the State directs the development of the country and operates mainly in the areas of promotion of employment, health, education, security, public services and infrastructure." (1993 Constitution, Art. 58).

As it can be appreciated, the economic model to follow is defined by both constitutions, but apparently the means to achieve it are not the same; therefore, we find two main problems: (1) Understand the definition of social market economy assumed by each constitution, (2) the means or policies to achieve such economic model.

However, this consideration is self-contradictory, since a social market

economy has *unambiguous* institutional elements which underlie to their structure and shape in a particular way the economic development, despite the *absence of a single type of social market economy*. The path on which this type of economic system is achieved, is intrinsic to its definition thus, it cannot be achieved by restrictive policies that favor the enforcement of only one type of institutions (public or private). Therefore, our first task is to identify if the economy sponsored by the constitutional law is consistent with the principles and dynamics that a social market economy seeks.

It should be clarified that this paper does not attempt to "judge" or "define" a unique type of market social economy; our aim is to apply a comparative analysis of the Peruvian constitutional law (1979 and 1993) and contrasting them with the "social market economy" as it has been conceived by the "Ordoliberalism". This analysis will contribute to identify convergence or divergence elements on this fundamental concept, exercise that contributes significantly to a *mutual understanding*.

As a first step, it is require to understand the hermeneutical concepts of the constitutional economic law. This is a difficult task, since both constitutional texts do not provide a clear definition of "social market economy" nor "subsidiary role of the state", which is also stated in the 1993 Constitution:

"The State acknowledges economic pluralism. The national economy is based on the coexistence of diverse forms of ownership and enterprise. Authorized only by law, the State can *subsidiarily* do business, directly or indirectly, due to high public interest or in real national interest" (1993 Constitution, Art. 60).

This is the reason why promoting *mutual understanding* is required, to analyze the level of symmetry existing between the concepts that guide and give structure to the economic environment in the European and Peruvian experience[8].

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[8] On history of Latin America thought see Popescu (1997) and Montecinos and Markoff (2009). A history of Peruvian economic thought was written by Reinaga (1969). On Peruvian economy see the classic work by De Soto (1989). For a comparison between the two Peruvian constitutions see Biagi (1997).

4.1. Historical Background

Before starting our analysis, we must ask why the government of Peru, after approximately 15 years of sustainable economic growth and being considered at present as one of the most solid economies in the region which hosts the best environment for business in South America (The International Bank for Reconstruction and Development / The World Bank 2010), wishes to return to the 1979 Constitution. For an outside observer, this situation would appear unreasonable. However, there remains the question of why Peruvians have elected a government whose plan of government actively promoted during the presidential campaign a constitutional change.

These simple questions demands a short review of the history of constitutional law instability in Peru. Table 1 summarizes the different constitutional laws that Peru has adopted since its republican history.

Table 1. Constitutions of Peru (1812-1993)

Year	In force (years)	Constitution
1812	11	Political Constitution of Spanish Monarchy
1823	3	Political Constitution of the Peruvian Republic
1826	2	Political Constitution of Peru
1828	6	Political Constitution of the Peruvian Republic
1834	2	Political Constitution of the Peruvian Republic
1836	0	Peru-Bolivian Confederation: Constitution of the South Peruvian State
1836	0	Peru-Bolivian Confederation: Constitution of the North Peruvian State
1836	1	Political Constitution Peru-Bolivian Confederation: Act 28th October 1836
1837	2	Political Constitution Peru-Bolivian Confederation
1839	17	Political Constitution of Peru
1856	4	Political Constitution of the Peruvian Republic
1860	7	Political Constitution of Peru
1867	53	Political Constitution of Peru
1920	13	Constitution for the Peruvian Republic
1933	46	Political Constitution of Peru
1979	14	Political Constitution of Peru
1993	18*	Political Constitution of Peru

Total 17 Political Constitutions. It means that in average each constitutions was in force about 12 years.

* Up to date

Source: Peruvian Congress

Due restrictions and scopes of the present papers, we start our review considering the Revolutionary Government of General Velasco Alvarado (1968-1975) characterized by a strong socialist and "anti-imperialistic" type of government, which seriously damaged the economic structure of the country.

During Velasco Alvardo government, the foreign mining companies and remarkable international industries (most American companies) in the

country were nationalized and a deep Agrarian Reform was applied. As a consequence, the productivity dropped significantly leading to severe losses in production and a growing social and economic marginalization[9]. It was during this period (1970) that Sendero Luminoso, the bloody Maoist, Marxist and Leninist terrorist group emerged, causing around 70.000[10] deaths in 30 years.

This political, social and economic instability led to a great popular unrest. In August 1975, a new coup d'état took place, and General Remigio Morales Bermudez took the power announcing the country would return to democracy in 1980. The announcement was certainly positive although it would imply five more years of military power. It is in this context that the 1979 Constitution was shaped.

Peru returned to democracy with the election of President Fernando Belaunde Terry (1980-1985), whose administration was characterized by a fall in the per capita income, increase of external debt and the strengthening of Sendero Luminoso. In 1985, Alan García (1985-1990) won the elections and (again) promoted populist measures that were fostered under irresponsible fiscal and monetary policies and ended plunging the country into a deep economic crisis having in 1990, a record inflation rate of 7,482%[11].

In this context Alberto Fujimori (president from 1990-2000) took office. Fujimori received a country in complete bankruptcy, growing terrorism and an economic structure created by military governments. In April 1992, Fujimori dissolved the Congress, and in November elected a new congress which would prepare a new Constitution.

In October 1993 the new Constitution was approved, and at present is in force. During this decade, important market reforms took place. Terrorism was defeated, and social programs were widely executed. However, in 2000 corruption comes to light forcing Fujimori to flee the country. A new transitional government led by Mr. Paniagua was established calling new elections won by Alejandro Toledo (2001 – 2006). Toledo consolidated the

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[9] It should be noted that during this period, the dependency theory of Raul Prebisch, in some extent also contributed to reinforce the policies of the Revolutionary Government.

[10] Comisión de la Verdad y la Reconciliación, 2003.

[11] Central Reserve Bank of Peru, historical statistics.

economic model, although his "trickle down" approach[12] did not defeat the poverty at the level that he expected. Alan Garcia has followed Toledo (2006 – 2011). Garcia's government will not repeat the damages caused in his first government concentrating therefore in the economic growth and keeping low inflationary rates.

Today, Peru has a solid economic situation, however social aspects were seriously neglected since the government has been focused in maintaining a solid macroeconomic stability. Few improvements have been made in recent years in relation to the quality of health, education, finance, environmental issues, security and other aspects, leaving unattended the vast majority of the population of the country.

Peru has today growth figures which contrast with the quality of life. GDP growth before the international economic crisis reach rate of 10% of growth; currently growth rates has been decline about 5,5% but still is a remarkable growth rate and the highest among Latin American countries. Nonetheless, the reduction of poverty rates are not so impressive as GDP growth rates and GDP per capital levels. Currently, one third of the country citizen leaves in poverty and about 60% of the economy is recognized as "informal".

Thus, it is verified a wide gap between the growth and poverty. Additionally, the predominant primacy of Lima (in population of people and firms), shows how country inequality has raised. Furthermore, it is observed a "business divide" between large companies (usually mining sector) and the micro enterprises (with 1 to 9 employees represent about 94% of the business units), where the linking element (medium enterprises) are almost absent, impeding the configuration of a wider and diversified manufacture sector that is required to support a vibrant middle class diffused in all the territory.

In other words, the "bread and butter" problems of the population have not been solved in spite of the important economic growth of the last years. The most important and positive reforms carried out during the Fujimori's Administration reflect the guidelines established by the Washington Consensus (1989), however the social and public management aspects have been neglected.

This statement is not necessarily a criticism of the postulates of the Washington Consensus, many of which helped stabilize the economy, boost

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[12] Toledo in several public communications indicate his policy of "chorreo" recalling the trickle-down economics.

trade, among other positive aspects; however, these instruments were not accompanied by solid social policies and institutional reforms.

The disproportion between growth without inclusion or growth without development, would be the explanation of why great part of the population have support a political party that promotes a constitutional change.

4.2. Comparative analysis of the 1979 and 1993 Constitutions[13]

In order to carry out a simple and accurate analysis, we have to selected main components of both constitutional laws (1979 and 1993) that affect the economic performance of the country. Such components that we analyze next are indicated below.

•   Private property and labor rights.
•   Characteristics of the economic policy structure: design and execution.
•   Investments.
•   Property and use of natural resources.
•   Education.
•   Health.

4.2.1. Private Property and Working Rights

Both constitutions have one key element in common; they acknowledge private property and labor rights. The property is recognized as inviolable and is therefore supervised by the State. Exceptions are allowed in cases of public interest declared by law and previous compensation. Likewise, as it will be analyzed below, the Constitution of 1993 limits expropriations done because of public interest, reducing in this way the arbitrariness of the State against the private property.

Additionally, in both constitutions the State recognizes that the worker is entitled to a fair and reasonable remuneration that will enable him to support his family so as to achieve material and spiritual welfare. The Constitution also recognizes the right to form unions and the right to strike always within a democratic framework.

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[13] The original constitutional texts that have been quoted area available in Appendix 1.

Key elements to allow a basic market operation are taking into account in both constitutions, although the 1993 Constitution raises the protection of the property rights.

4.2.2 Characteristics of the economic policy: Its design and implementation

The differences between the two constitutions in certain economic areas are not superficial. The 1979 Constitution, hereinafter C79, shows elements that indicate a type of planned economic policy that considers the State as the great designer and main executor of economic policies. In this sense, the 1993 Constitution, hereinafter C93, shows a State that tends more to foster progress through the promotion of employment and education policies, that is, indirect policies to promote economic development. This is an element that will differ significantly from the C79.

1979 Constitution	1993 Constitution
Article 111. The State formulates social and economic policies by means of development plans regulating the activity of the other sectors. Once the planning is agreed, it is mandatory.	Article 23. The State creates conditions for social and economic progress promoting productive employment and education for work.

These considerations bring up the debate on industrial policy, which enjoyed wide circulation in Latin America specially under the leadership of Raul Prebisch of CEPAL and thereafter was harshly criticized for its negative effects. In this respect the C93 suggests the abandonment of such policies fostering indirect interventions.

The C79 accepts a variety of forms of enterprises and points out a state business activity different from the C93, which indicates that business activity of the state can only be carried out on a subsidiary perspective requiring thus a specific law for its execution.

1979 Constitution	1993 Constitution
Article 112. The state guarantees economic pluralism. The national economy is based on democratic coexistence of different forms of ownership and enterprise. State enterprises, private, cooperative, self-managed, community and other type of businesses act under the legal representation stated in the law according to their characteristics. Article 113. The state does its business in order to promote the economy, public services and achieve the development goals.	Article 60. The state acknowledges economic pluralism. The national economy is supported in the co-existence of various forms of ownership and enterprise. Only by a passed law, the State can subsidiarily carry out business activities, direct or indirectly, by reason of high public interest or for national interest.

The C79 grants the State a leading role in the business activity, in order to achieve the development of the country, while C93 gives the State a subsidiary role, a key aspect for the configuration of a "social market economy". Nevertheless, it is observed that this subsidiary role is limited – by the usage of specific laws- also in the case of indirect action to foster the economy. We will come back to this observations later.

4.2.3 Direct Foreign Investments

1979 Constitution	1993 Constitution
Article 137. The State authorizes, registers and monitors direct foreign investment (...).	Article 62. The freedom to contract guarantees that the parties may validly agree upon in force of regulations at the time of the contract. Contract terms cannot be modified by legislation or other provisions of any kind. By law-contracts, the State may establish guarantees and grant securities. They cannot be modified by legislation, without prejudice to the protection referred to in the preceding paragraph. Article 63°. The domestic and foreign investments are subject to the same conditions.

As it can be appreciated, the differences between both constitutions are evident. While the C79 in its Article 137 seems to take a defensive approach towards foreign investment, the C93 offers high guarantees for foreign investments recognizing the inviolability of any type of contract which cannot be modified by any law. This absolutely guarantees the beginning of a business. Likewise, C93 highlights the contract-law, by which the state may provide additional guarantees for investments.

These differences are relevant: although C93 promotes substantially foreign direct investment and indicates equal conditions between national and foreign companies, a close analysis shows a sort of discrimination against national investment, since the law-contracts (with particular benefits) and the additional guaranties would represent better conditions and benefits than those offered to domestic companies creating in this way a possible unbalances between the benefits provided to foreign and local companies. In this regard, the C93 has more capacity to attract foreign investment, but could lead(ed) to a kind of policy of "picking winners and losers".

4.2.4 Property and management of natural resources

Norms that regulate natural resources are of great importance in an economy and geography such as the Peruvian one, where the mining activity is prevailing. Both constitutions state that natural resources – renewable and nonrenewable – constitute patrimony of the nation. In case of private operation, the State grants exploitation rights.

However, there is a difference between both constitutions. C79 stresses in particular the development of mining activity. Furthermore, it grants an exclusive right to the Amazon region, which represents the 60% national territory. In this way, more of the half of the national territory becomes "split" by a different economic framework. Additionally, other depressed areas, such as highlands, are not taken into account. This creates a distortion in vast areas, leaving small policy range to support specific areas.

1979 Constitution	1993 Constitution
Article 118. The renewable and nonrenewable natural resources are the patrimony of the nation. The law establishes the conditions for their use and its granting to individuals. Article 120. The State encourages the development of the Amazon Region it giving special treatment when required. Article 121. Corresponds to the areas where natural resources are located, an appropriate share in the income produced by its exploitation, consistent with a decentralist policy. Article 122. The State promotes and stimulates the mining activity. Protects small and medium scale mining. Promotes the mining sector. Acts as employer and in other forms prescribed by law. It is mandatory to work the mining concession and gives the owner a property right, subject to the conditions of the law.	Article 66. Renewable and nonrenewable natural resources are patrimony of the Nation (…). The concession grants its owner a real right, subject to such legal regulation. Article 69. The State promotes sustainable development of the Amazon Region by means of an adequate legislation.

4.2.5 Education and Health

Within a framework of a social market economy, it cannot be left unattended those aspects related to education and health. In regards to the first item we note an important difference between the C79 and C93.

1979 Constitution	1993 Constitution
Article 25. It is mandatory the elementary eduation in all its modalities. Education provided by the State is free at all its levels(…). Article 30. The State acknowledges, helps and supevises prívate, cooperative, community and municipal education which will be nonprofit. (…) All natural or legal person is entitled to form educational centers respecting always the constitutional principles.	Article 17. Childhood, elementary and high school education are mandatory. Education is free in State Centers. The State guarantees the right to free education in State universities to those students who maintain a satisfactory record performance and who do not have the economic resources to pay for their education. With the purpose of guaranteeing greater plurality in the educational offer, and in favor of those who cannot pay for it, the law establishes that the way to subsidize private education in all of its modalities, including communal and cooperative.

The C93 extends this mandatory aspect and therefore free up to high school. However, the most relevant aspect is given in the Art. 30 of the C79, which explicitly states that education as a nonprofit activity. This element is not considered in the C93. Nonetheless, it clearly states the possibility that the state can subsidize the private education and other modalities.

1979 Constitution	1993 Constitution
Article 25. The elementary education, in all its modalities, is mandatory. The education supplied by the State is free in all the levels (…). Article 39. The State recognize, support and supervise the private education, cooperatives, communal and local which will not have profit aims. (…) All persons, natural and juridicals have the right to create, without profit aims, educative centers within the respect of the constitutional principles.	Article 66. The elementary and secondary education is mandatory. In the public institutions the educations is free. In the public universities the State guarantees the right to be freely educated to those students that maintain a satisfactory performance and do not have the enough economic resources to support their studies. With the aim to guarantee with more plurality the educational supply, considering those that are not able to afford their education, the law indicates the way to subsidize their private education, including the municipal and cooperative.

This aspect is of extreme importance since during Fujimori's Administration because the development of educational businesses increased largely. On one hand it increased the supply of education – particularly private – but on the other hand the cost of education increased enormously, becoming a truly pro-profit sector, harming families' budget. This opens an interesting debate, because if the government would be able to support indirectly the private schools or at least would have the possibility to offer better public institutions, it would reduce a sort of monopoly that has been created in the sector, particularly in the capital city.

In regards to health systems, both constitutions promote free and wide services; nonetheless it is interesting that the C93 considers a wider participation of different type of actors (private, public or mixed solutions). Nonetheless, the problem seems to be similar to the educational sector. The lack of direct or indirect support to private initiatives and the poor public supply of health is making too expensive health services, harming families' budget and reducing significantly its quality of life.

We observed that, although the indication of the subsidiarity role of the state in the C93, it has not being widely exerted. Additionally, it seems that if a sort of fear to this subsidiary role exists, probably this is a typical case of misunderstanding concepts.

4.2.6 What kind of social market economy pursues the C79 and the C93?

This question is difficult to answer due the absences of definitions in both constitutional laws. Nonetheless, considering the analysis done, we can get some elements.

The C79 considers a prominent role of the state as a central planner, main designer and actor of the economic development of the nation. Foreign direct investors seem to be perceived as necessary but representing a potential threat. An economic policy that looks for sectors selection (picking winners and losers) is observed, particularly mining and agriculture. By the other hand the state intends to guarantee some basic services and clearly states that education cannot have profit aims, remaining as non for profit services.

The type of "social market economy" that emerged from the analysis of the C79 indicates an economic system particularly shaped by the role of the central state, which only requires the role of the private or foreign investors, inasmuch as these provide economic sources to the central government which would become the main distributor of the resources. Additionally, the concern of the natural resources and its protection is not environmental-oriented and foreign investor seem not to be considered as potential partners that contribute with the development of a community and vice-versa. Although these elements are more familiar with a planned economy structure, it is remarkable that C79 considers some typical "market oriented sectors" and "social oriented sectors" that are important elements to configure a social market economy.

The C93 presents several elements that we consider closer to the idea of "social market economy" in the European perspective. Elements such as the subsidiary role of the state, the integration of the private sector as potential provider of social services and the consideration of the state as "promoter" and not "owner" of the development of the country are important. Nevertheless, we observe mismatches between their economic constitution and the way in which the economy and the social aspect evolve. The contract-laws particularly used during the 90s to attract FDI were certainly necessary, nevertheless could reinforced traditional economic sectors.

Moreover, strong policies (direct or indirect) towards small business were not applied, reducing the possibility to create a wider and more mature manufacture sector, essential to create wider middle class.

We also observe, that the government has not used the possibility that law provides under a subsidiary code, such as the indirect support to private education. Instead, it has indirectly promoted a sort of educational and health markets that only a small part of the population can achieve. Rather than providing adequate policies to enhance the subsidiarity (horizontal and vertical), it seems that policies had foster a concentration of the economic power, with consequences in the concentration of population (Lima hosts about 50% of the GDP, about 52% of the business units and about 30% of the country's population) and therefore producing marginality.

As a consequence we observe a move in the policy setting. From a political concentration to an economic concentration, where both have left a large size of the population at the margin, fact that would explain the current political situation. But, is it really the constitutional law, which can change these patterns? Can the law change a country?

In some extent the answer could be positive, especially if we do not operated under market economy or under a socialist or communist system. Nevertheless, when the basic conditions for a market economy exist and the elements that can pursue a social market economy are present, we think that a change in the constitution can be self-defeating. It means that with the current constitutional framework a "possible social market economy" can be promoted, fact that would be much more difficult with the C79.

As example, with the current constitution the Peruvian state can enhance a truly subsidiary role in strategic sectors such as health, education and infrastructure, role that currently is acting although its weakness. The subsidiarity, the participation, the support to lower layers and other aspects are inherent to the political activity. In our opinion, a renewal perspective of the policies and initiatives is required, rather than a new constitutional law. Peru has already followed the negative path of constitutional instability; 17 constitutions are witnesses of the fact that changes in constitutions do not guarantee changes in society. The political *momentum* is giving signs that the debate should be more focused on citizen-center solutions, where the discovery of subsidiarity and its capacity to transform economic success in a social one. Under this perspective the enhancing a mutual understanding between Europe and Peru can produce concrete and long lasting benefits.

5. A Brief Conclusion

In the first section, we have described some basic features of the so-called Social Market Economy Model conceived by the Ordoliberalism School. It is an attempt, firstly experienced in Germany, to conciliate the classical economic freedoms with the modern social rights.

In the second section, we have examined the economic constitution of Europe which outlines a model of social market economy. According to the constitution, public authorities have to promote a "smart, sustainable and inclusive growth", and they have to implement a set of interventions conformable to the subsidiarity principle.

In the third section, we have explored in-depth the economic constitution of Peru reconstructing the key passage from the charter of 1979 to that of 1993. Both outline a model of social market economy which commit public authorities to have an active role in promoting an inclusive growth that cannot be achieved only by government centered actions but also with an active participation of social forces.

What do the economic constitutions of Europe and Peru have in common? Our conclusion is that they share a model of social market economy based on the subsidiarity principle and oriented towards a target of high employment and not just of public assistance. This is only a first step in the direction of increasing the "mutual understanding" of two regions which want to cooperate.

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Appendix 1

Original constitucional texts

Constitución 1979	Constitución 1993
Artículo 115. La iniciativa privada es libre. Se ejerce en una economía social de mercado. El Estado estimula y reglamenta su ejercicio para armonizarlo con el interés social.	Artículo 58. La iniciativa privada es libre. Se ejerce en una economía social de mercado. Bajo este régimen, el Estado orienta el desarrollo del país, y actúa principalmente en las áreas de promoción de empleo, salud, educación, seguridad, servicios públicos e infraestructura.

Constitución 1993
Artículo 60. El Estado reconoce el pluralismo económico. La economía nacional se sustenta en la coexistencia de diversas formas de propiedad y de empresa.Sólo autorizado por ley expresa, el Estado puede realizar subsidiariamente actividad empresarial, directa o indirecta, por razón de alto interés público o de manifiesta conveniencia nacional.

Constitución 1979	Constitución 1993
Artículo 111. El Estado formula la política económica y social mediante planes de desarrollo que regulan laactividad de los demás sectores. La planificación una vez concertada es de cumplimiento obligatorio.	Artículo 23. (...) El Estado promueve condiciones para el progreso social y económico, en especialmediante políticas de fomento del empleo productivo y de educación para el trabajo.(...)

Constitución 1979	Constitución 1993
Artículo 112. El Estado garantiza el pluralismo económico. La economía nacional se sustenta en la coexistencia democrática de diversas formas de propiedad y de empresa. Las empresas estatales, privadas, cooperativas, autogestionadas, comunales y de cualquier otra modalidad actúan con la personería jurídica que la ley señala de acuerdo con sus características.	Artículo 60. El Estado reconoce el pluralismo económico. La economía nacionalse sustenta en la coexistencia de diversas formas de propiedad y de empresa.Sólo autorizado por ley expresa, el Estado puede realizar subsidiariamente actividad empresarial, directa o indirecta, por razón de alto interés público o de manifiesta conveniencia nacional.

Constitución 1979	Constitución 1993
Artículo 137. El Estado autoriza, registra y supervisa la inversión extranjera directa y la transferencia de tecnología foránea como complementarias de las nacionales, siempre que estimulen el empleo, lacapitalización del país, la participación del capital nacional, y contribuyan al desarrollo en concordancia con los planes económicos y la política de integración.	Artículo 62. La libertad de contratar garantiza que las partes pueden pactar válidamente según las normas vigentes al tiempo del contrato. Los términoscontractuales no pueden ser modificados por leyes u otras disposiciones decualquier clase. Los conflictos derivados de la relación contractual sólo se solucionan en la vía arbitral o en la judicial, según los mecanismos de protecciónprevistos en el contrato o contemplados en la ley.Mediante contratos-ley, el Estado puede establecer garantías y otorgarseguridades. No pueden ser modificados legislativamente, sin perjuicio de la protección a que se refiere el párrafo precedente. Article 63°. La inversión nacional y la extranjera se sujetan a las mismas condiciones.

Constitución 1979	Constitución 1993
Artículo 118. Los recursos naturales, renovables y no renovables, son patrimonio de la Nación. Losminerales, tierras, bosques, aguas y, en general, todos los recursos naturales y fuentes de energía, pertenecenal	Artículo 66. Los recursos naturales, renovables y no renovables, son patrimonio de la Nación. El Estado es soberano en su aprovechamiento. (…). The concession grants its owner a real right, subject to such legal

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Estado. La ley fija las condiciones de su utilización por este y de su otorgamiento de los particulares.Article 120. El Estado impulsa el desarrollo de la Amazonía. Le otorga regímenes especiales cuando así se requiere. Una institución técnica y autónoma tiene a su cargo el inventario, la investigación, la evaluación y el control de dichos recursos. Article 121. Corresponde a las zonas donde los recursos naturales están ubicados, una participación adecuada en la renta que produce su explotación, en armonía con una política descentralista. Su procesamiento se hace preferentemente en la zona de producción. Article 122. El Estado fomenta y estimula la actividad minera. Protege la pequeña y mediana minería. Promueve la gran minería. Actúa como empresario y en las demás formas que establece la ley. La concesión minera obliga a su trabajo y otorga a su titular un derecho real, sujeto a las condiciones de ley

regulation. Article 69°.- The State promotes sustainable development of the Amazon Region by means of an adequate legislation.

Constitución 1979	Constitución 1993
Artículo 25. La educación primaria, en todas sus modalidades, es obligatoria. La educación impartida por el Estado es gratuita en todos sus niveles, con sujeción a las normas de ley. En todo lugar, cuya población lo requiere, hay cuando menos en centro educativo primario. La ley reglamenta la aplicación de este precepto. Se complementa con la obligación de contribuir a la nutrición de los escolares que carecen de medios económicos y la de proporcionarles útiles.	Artículo 17. La educación inicial, primaria y secundaria son obligatorias. En las instituciones del Estado, la educación es gratuita. En las universidades públicas el Estado garantiza el derecho a educarse gratuitamente a los alumnos que mantengan un rendimiento satisfactorio y no cuenten con los recursos económicos necesarios para cubrir los costos de educación. Con el fin de garantizar la mayor pluralidad de la oferta educativa, y en favor de quienes no puedan sufragar su educación, la ley fija el modo de subvencionar la educación privada en cualquiera de sus modalidades, incluyendo la comunal y la cooperativa.